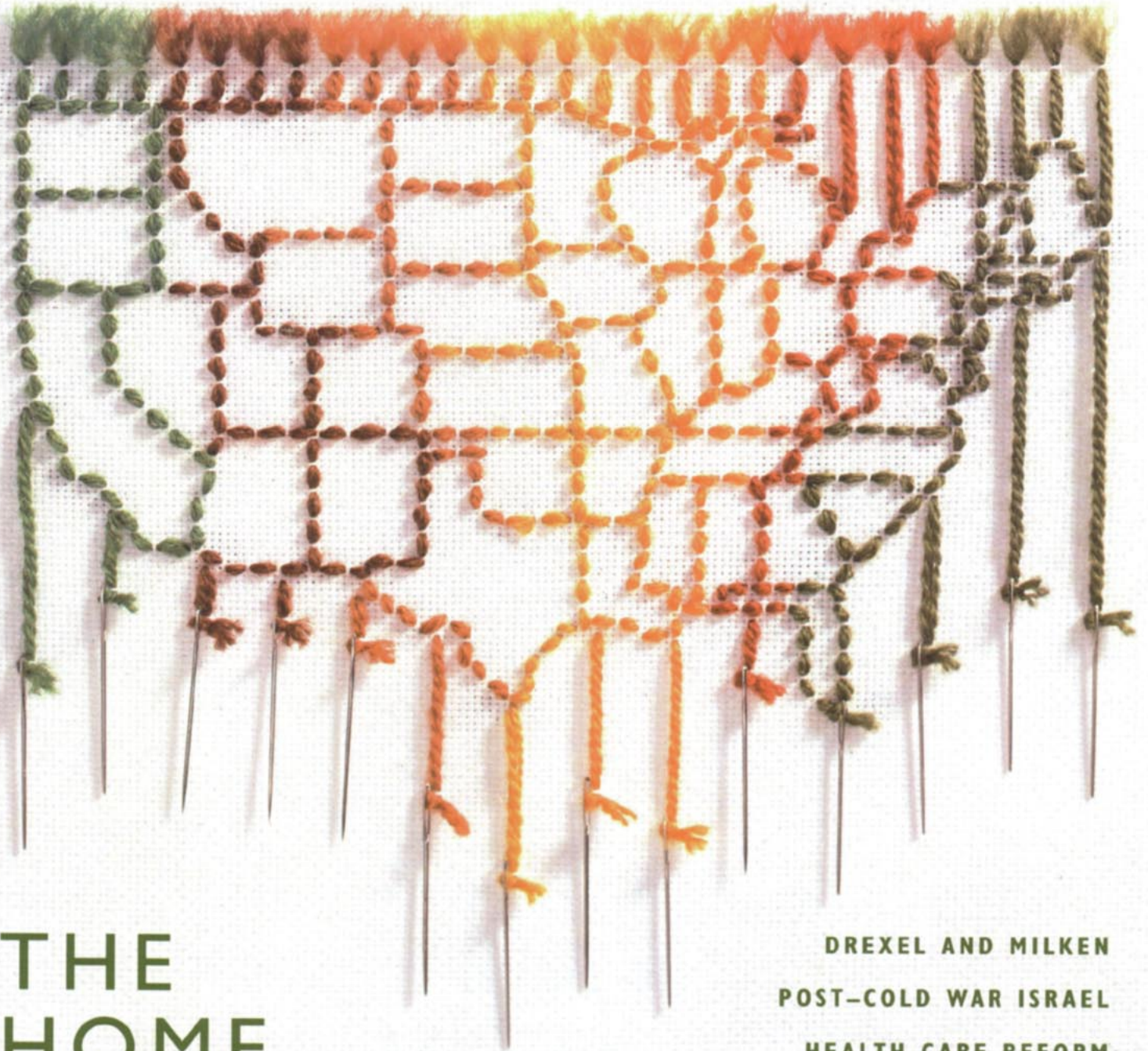


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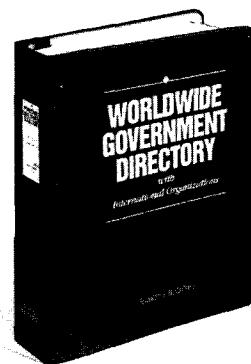
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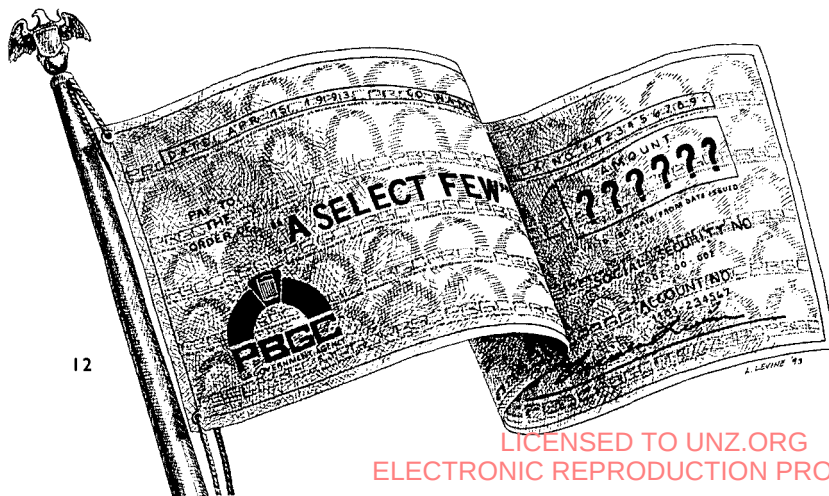
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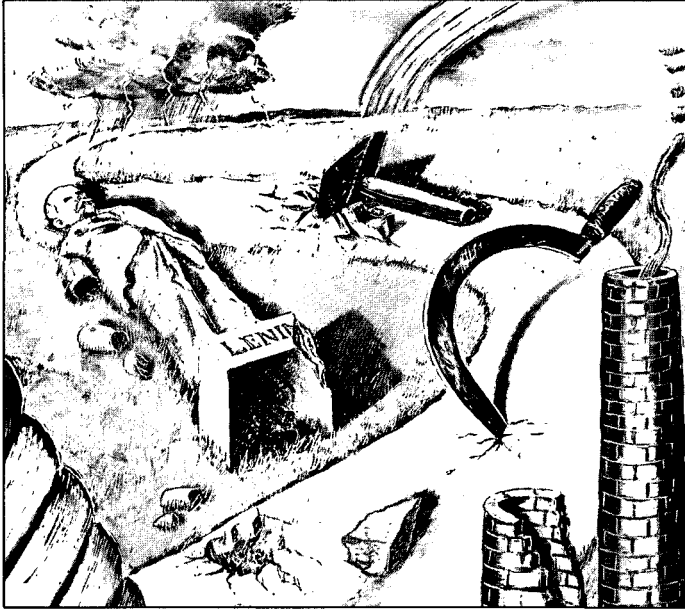
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Please Don't Feed the Industrial Dinosaurs



■ In "On the Road to Paradise Again?" (winter issue), Jerry Hough misunderstands the economics behind what has gone wrong in Russian reforms and misrepresents the alternative advocated by Arkady Volsky and the industrialists.

It is true that money has been loose rather than tight in Russia since January 1, 1992. But Hough is wrong in arguing that inter-enterprise loans do not create money. This "ar-rears" problem arose when enterprises continued to supply their traditional customers despite not being paid. In effect, suppliers extended credit to their customers just as they too were effectively borrowing from their own suppliers.

Hough fails to recognize that inter-enterprise credits did indeed increase the money supply, as the Central Bank of Russia, in Hough's words, "issued money to cover loans and wages already committed." Every time a loan is made, money is created. To be sure, during the first half of the year the rate at which money was created in this way on the balance sheets of enterprises was

not matched by the rate at which zeros were added to paper currency in the hands of the public. As a result, enterprises had the bank balances to pay their workers, but not the paper money to do so, creating the temporary "cash crisis." But such partial and crude monetary control did not offset the effect of inter-enterprise credits, which rose from a few hundred million rubles in January to an estimated 3 trillion by July.

For the same reason, Hough is also wrong when he argues that the non-Russian republics couldn't create rubles to throw on the inflationary bonfire in Russia proper. By issuing ruble-denominated credits to Ukrainian enterprises, the Central Bank of Ukraine created bank balances that firms spent on Russian goods and services. Indeed, that they had every incentive to suck goods from Russia in this way was clear very early, and the only surprising thing is that it took until July for the Russians to put a stop to it.

That said, Hough is right on several important points. First, "capture banks" created and

owned by the enterprises to whom they lend are a major problem, and their existence requires much greater regulation. Greater power to regulate the transition, however, is precisely what the Gaidar team never had. Rather, they were a handful of visionaries trying to turn an enormous ship around, rather like the Bolsheviks in 1917. Often, when the Gaidar team could not control a process, they chose to legalize it, rather than to weaken themselves further by fighting a losing battle.

Second, Hough is right that many of the enterprises who received Central Bank credits were bankrupt by any standard. This credit was rationed on the basis of the firm's "importance to society," in practice the political leverage of the firm. In effect, the Gaidar team lacked the political power to control the Central Bank of Russia, which is formally subordinate to the legislative branch. Gaidar strove for a tight monetary policy, but was politically unable to achieve it. He and his team were forced to make compromises with powerful interests in the regional governments and in heavy industry, and it is unfair for Hough to suggest that Gaidar covertly favored easy credit.

Third, Hough points out that Gaidar's adoption of Polish "shock therapy" rather than Chinese gradualism represents "deindustrialization" for Russia. The industrialists are outraged at the prospect of Russia becoming, in Volsky's words, "a resource appendage" of the Western powers. But when much of Russian industry destroys more value than it creates, deindustrialization is a good thing. Russia will be the wealthier for it.

A massive military-industrial complex and a huge heavy industrial sector, neither of which faces significant demand for its

products in a market economy, can be supported in one of only two ways: either by direct subsidies that add to the government deficit or (which often amounts to the same thing) by easy credit. Both approaches are extremely inflationary, as events of 1992 have shown. Supporting the industrial dinosaurs risks hyperinflation and economic collapse, a politically dangerous outcome that is in the interest of no one.

Merton J. Peck and Thomas J. Richardson, Yale University

Distorting Antitrust Laws

■ William Bowen and David Breneman ("Student Aid," winter issue) make a useful distinction between educational institutions that coordinate financial support of students in order to spread benefits and increase diversity, as against those seeking increased enrollment and improved finances. The distinction helps to pinpoint the absurdity of the position of the Department of Justice and Judge Bechtle in the MIT antitrust case.

The antitrust laws always lend themselves to distortion. Heretofore, their most egregious misuse entailed anticompetitive litigation by inefficient firms seeking court protection by attributing the success of their rivals to predatory behavior. Now it is proposed to distort the antitrust laws by extending their reach beyond commercial activity to prohibit socially beneficial coordination among nonprofit institutions.

The economic efficiency criterion that increasingly guides antitrust hearings shows clearly that price collusion by profit-seeking horizontal competitors merits condemnation. However, when that is not the issue it is widely recognized that coordination can be beneficial, as in the case of cooperative in-

vestment in R&D by a group of firms. I cannot imagine any efficiency gains from a ban on coordination of student support decisions. The sure consequence will be inflation of awards to applicants who are most anxiously sought after by colleges and universities and shrinking of educational opportunities to other highly qualified persons, to their detriment and that of society.

The inappropriateness of this misapplication of the antitrust laws is suggested by analogy. The widely accepted Areeda-Turner predatory pricing test indicates that prices violate antitrust rules on predation if they lie below the average variable costs of the products in question. As we know, however, almost all institutions of higher education charge tuitions well below the pertinent costs. Are they, then, vulnerable to the charge of predatory pricing? Should they be forced to raise tuitions forthwith?

*William J. Baumol,
New York University*

To Market, to Market

■ William Bowen and David Breneman ("Student Aid," winter issue) argue that schools such as MIT ought to be allowed to form agreements on how and to what degree to grant financial aid to students in the name of efficiency. The schools, they argue, should not be condemned for trying to provide an excellent and affordable education to as many students as possible while freeing up money that could be spent on books, computers, and laboratories.

But what Bowen and Breneman really argue for is setting a price floor under which the price of tuition may not be lowered to attract more highly desired students. Price floors produce inefficiency; they don't allow resources to go to their most valued use, and, most im-

portant, they encourage non-price competition. When schools restrain themselves in the levels of financial aid offered, they will compete for more highly valued diverse students with extravagant admission offices and publications, greater numbers of expensive student contacts, and banquets with speakers and faculty diverted from their educational pursuits.

Nor is this simply an issue of financial aid and students. These very same arguments can and have been made for setting price ceilings on salaries offered in attracting and retaining more highly valued faculty to minimize the cost of instruction.

Like Bowen and Breneman, I applaud these schools' attempts to provide the strongest education to the broadest array of qualified students. But I must nonetheless suggest that collusion can never preclude competition for scarce and valued resources whether it be in the market for students today or in the market for faculty tomorrow.

Brian Mantel, Wabash College

Reinventing the NEA

■ Michael Dorf ("Artifactions," winter issue) is correct that recent "battles" over the National Endowment for the Arts have been a distraction from serious questions of leadership and direction. It's time to rethink the NEA. The environment in which the agency operates has changed dramatically in the past 27 years. One widely publicized change is the increased polarization of the nation on certain social and cultural issues. Navigating that turbulence requires exceptional leadership, and President Clinton's selection of a new chairperson will be a crucial piece in reinventing the NEA.

Another crucial piece will be providing the chair with the staff and resources to do

the job. Extraordinary turnover in key staff and program positions at the endowment has weakened the agency's institutional memory and policy continuity. Understaffing in congressional affairs, research, inter-agency liaison, information systems, and education projects has undercut the agency's capacity to respond to either crisis or opportunity. Under such circumstances, even an exceptional chairperson will be hard pressed to exercise effective leadership.

The second change lies in the national arts environment itself—an issue that has been virtually lost sight of in the recent battles. The economics of the arts as well as the size, distribution, and diversity of the arts community have changed the arts ecology. An inter-governmental system of public arts support has developed at the state and local levels. All elements of the arts creation, production, delivery, and participation system have matured into a truly national resource. Public investment matched many times over with private support has succeeded in making more of the arts available to more citizens in more parts of the country than ever before. Yet this very success gives rise to a need to reevaluate the philosophy, purposes, priorities, and structure of the agency.

Perhaps the advent of a new administration will give us the opportunity to transform the battle cries into a productive cultural discussion.

*Margaret J. Wysomirski,
former staff director,
Independent Commission
on the NEA*

Don't Quarrel with Success

■ Although the NEA was certainly rocked by controversy in the last two years of the Bush administration (Michael Dorf, "Artifactions," winter issue), the Clinton administration

should step back for a dispassionate review of NEA history before trying to "fix" anything.

The primary mission of the NEA has been to be a catalyst—for more art and for more support of the arts. It has met its goals and then some. Just as one example, its grants, worth \$119 million in just one year, 1988, generated \$1.36 billion in private funds. More than any other federal agency the NEA has helped reshape the face of America. In 1965, when the NEA was established, there were 60 professional orchestras in the country; today there are more than 230. In 1965 there were 37 professional dance companies; today there are 250. In 1965 there were 56 professional nonprofit theater companies, mostly in New York and on the West Coast; today there are more than 400 across the country. In 1965 only five states supported the arts with state appropriations of just over \$2.5 million. Today every state has its own arts agency, with state appropriations at the \$200 million mark.

The statistical record is astounding, and the NEA's mission remains sound, despite the unsettling environment of the past few years. In 1990, when there were complaints about one grant involving Maplethorpe, another 4,475 grants were being awarded to groups across the country. And those 4,475 grants were generating more than a billion dollars of support from other private and public sources.

No other agency in Washington can claim such a record, regardless of the fuss about one or two grants. That kind of success does not need fixing.

*Milton Rhodes,
American Council for the Arts*

The Review welcomes comments from its readers. Letters will be edited to conform to style and space.

Clinton's Realistic Economic Vision

BY BRUCE K. MACLAURY

Finally the American people are being treated as intelligent citizens by their president. In his February 17 economic message to Congress, President Clinton laid out forthrightly what we must do to restore self-respect at home and our claim to leadership abroad.

Americans are not fools. It had become obvious that the rhetoric of divided government in Washington was, if not totally cynical, at least increasingly removed from reality. Promises of deficit reduction were appropriately discounted so long as no credible program backed them up. And for anyone who had even a vague sense of budget realities, there could be no credible program without sizable tax increases as well as spending cuts.

Policy wonks, including those at Brookings, had been trying to drive this point home for years. But their call to consume less and invest more fell on deaf ears. Why? Many Americans, especially those with limited education, were already consuming less as their wages fell. In any case, why pay more taxes when government programs were portrayed as either wasteful or ineffective or both? Finally, by definition the benefits of investment (and deficit reduction, or saving) are mostly in the future (that is, beyond the next election).

Indeed, candidate Clinton placed more emphasis during his campaign on the social deficit of American families trapped in welfare, lacking medical insurance, disserved by an overburdened education system, and facing job losses, than he did on remedies for the economic deficit. It fell to Ross Perot, that high-tech guru with his low-tech charts, to dramatize what many instinctively understood: that piling debts on debts was stealing the birthright of his grandchildren—and ours. And to tell us we couldn't get

out of this mess without a big tax hike—in his case, a gas tax.

Journalists have a lot of fun pointing out how many campaign promises successful candidates break. And to be fair, that's part of their job. The public deserves to know whether a candidate was elected on the basis of dreams and falsehoods. There's no denying that candidate Clinton held out the hope that middle-income Americans could look forward to tax relief, whereas as president, he is now telling them that they too must contribute to deficit reduction. I ascribe this broken promise more to a belated acceptance of reality than to premeditated hypocrisy. But however that may be, the economic program that the nation is now debating would simply not add up without broad-based revenue increases.

Are there worries about what the president has proposed? Perhaps the biggest is that his program, or something like it, is picked apart by those who dislike this or that detail, and thus fails to pass Congress. That would indeed be a tragedy, not because the nation would quickly reach a crisis, but because we would continue to mortgage our future. And future politicians, remembering both Mondale and Clinton, would have even less incentive to try to stop the rot.

A second worry is that far from creating jobs, the drag of fiscal restraint will cut short the expansion that only now seems to be picking up steam. Yet, this risk to cyclical recovery seems small compared with the much greater risk of failing to deal with the economy's structural fatigue. In any case, the short-term stimulus package of investment incentives and jobs programs is a reasonable hedge against this risk.

A third worry is that the president's economic proposals will become hostage to health



care reform in a debate that could derail both. He is certainly correct to warn the American public that without effective curbs on health care costs, there is no hope of keeping future budget deficits under control. And budget reality requires it to be said now that the eventually large costs of providing medical coverage for the millions now uninsured will necessitate yet more tax increases, apart from any projected cost savings. But the complexity of the health care issue, and the lack of consensus on its solution, argues for delaying congressional consideration of health care until the rest of the economic package has had its day in court.

Finally, the president is still talking only about *reducing* the deficit, not eliminating it. If his program were passed as proposed, and if health care reform added no net costs, the 1997 deficit would still be about \$200 billion, or 2½ percent of GDP. That's a big accomplish-

ment but far from total victory, especially since we will still be relying on Social Security surpluses to hold down the overall deficit numbers.

Deficit reduction is not just sacrifice, it is sanity. A nation that saves only 2 percent of its income cannot remain a world leader, however lofty its rhetoric and compelling its ideals. Economic growth and social equity demand investment, mostly in the private sector, but some in the public sector as well. Investment is not just a new word for spending. It is an age-old concept that focuses on how we spend and how we pay for it. President Clinton has provided a vision and a program that gives that new focus reality. It is possible to have other visions, but they too must add up to reality. ■

Bruce K. MacLaury is president of the Brookings Institution and has served in that capacity since 1977.

K E N N E T H A . S M A L L

URBAN TRAFFIC CONGESTION

A New Approach to the Gordian Knot

Kenneth A. Small is professor and chair of economics at the University of California at Irvine and an associate of the University of California Transportation Center. He is the co-author, with Clifford Winston and Carol A. Evans, of Road Work: A New Highway Pricing and Investment Policy (Brookings, 1989). Parts of this article are adapted from an article to be published in a forthcoming issue of Transportation magazine.





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As traffic policy in the United States has lurched from the contentious highway building of the 1960s to the ineffectual travel-demand management of more recent years, congestion in the nation's cities has worsened steadily. In his recent book, *Stuck in Traffic*, Brookings' urban policy expert Anthony Downs threw up his hands and advised motorists, only partly tongue-in-cheek, "to learn to enjoy congestion."

It is hard to imagine frazzled American drivers taking that advice. And in fact they may not need to. The time may soon be ripe for a radically new approach to the problem of urban congestion.

Dreams and Nightmares

Economists have long recognized that congestion can be dealt with simply and efficiently by charging motorists a very high premium for using the most popular roads during peak hours. But economists' dreams can be politicians' nightmares, and "congestion pricing" is no exception. Charging people for what has been free is no more popular in the United States than it is in Russia. And the efficiency rationale for making motorists pay steep fees to commute to and from work in Los Angeles is no more self-evident than that for raising the price of sugar in St. Petersburg.

Still, interest in congestion pricing is growing and has reached far beyond academia. A surge of conference activity has brought it to the fore among transportation planners and even some politicians. Important interest groups, ranging from business organizations, such as the Bay Area Economic Forum, to environmental groups, such as the Environmental Defense Fund, are now open advocates. European policy analysts are infatuated, with Britain embarking on a third and massive study of how congestion pricing would work in London. In the past eight years, politicians nearly (but not quite) signed off on trials in Hong Kong, Norway, Sweden, the Netherlands, and Cambridge, England. The government of Chile is seriously considering it.

A few systems have even been implemented. Singapore has had a citywide system since 1975. In April of last year France began applying congestion pricing to Sunday traffic on the A1 motorway into Paris. California is planning congestion pricing on at least two of the four privately built highways recently contracted for by the state.

Why the sudden burst of interest? Several developments have combined to give currency to the unthinkable. For one thing, the failure of all other congestion policies gives new allure to drastic options. In addition, technology has made long waits at toll booths obsolete. From here on out toll collection can be nonintrusive and easy for the traveler. And finally, the potential of congestion pricing as a prodigious source of much-needed new revenue is being recognized by local, state, and federal officials alike.

Failures of the Past

Congestion, obviously, is a matter of too few roads carrying too many cars and trucks. Most suggested remedies attempt to rectify the imbalance either by in-

creasing the supply of roads or by reducing the number of vehicles. Among the former remedies are constructing or widening highways, improving signal timing, and (more futuristically) using electronic sensors to allow closer vehicle spacing. All require large public outlays. Strategies to reduce demand include parking controls, ridesharing, mass transit, employer-based commuting requirements, staggered work hours, telecommuting, and measures to encourage workers to live closer to their jobs. These policies are costly too—not in terms of public spending, but in terms of changing people's behavior. High-occupancy-vehicle lanes are a combination of supply- and demand-side policies: they usually put new capacity in place and at the same time promote carpooling.

But these steps relieve congestion only temporarily. Once traffic begins to thin out a bit, heretofore respectable folks who have eschewed antisocial activities like driving to work alone find reasons to join the immoral majority. All sorts of people in changed circumstances—new workers, people who just moved, young professionals with new families—find, in greater numbers than before, that solo driving during peak hours is just what they need to juggle their busy lives. Evidence for this abounds in before-and-after studies of travel choices when lanes are added, bridges opened or closed, transit lines installed.

Every large congested city in this country harbors a reservoir of potential peak-period drivers, a sort of reserve army of the unfulfilled, more prosaically known as *latent demand*. Congestion itself deters them from traveling when and where they would prefer—namely, on busy streets and highways during peak hours. As soon as additional road space appears because of a policy "success," it is taken by someone who was once part of that latent demand.

Conventional congestion policy fulfills the desires of latent demanders for more convenient travel—a genuine and important benefit. But it does not eliminate congestion or even reduce it much for any length of time.

The Role of Congestion Pricing

Congestion pricing would break this cycle by using money—instead of congestion delay—to ration scarce capacity. This approach is more efficient because time spent in congestion delay is lost forever, so is a real drain on national resources. By contrast, tolls paid by travelers can be spent on something useful or just substituted for some other revenue source; the only net costs are those of collecting the tolls—and with today's technology, they are minimal.

Congestion pricing is also a demand-side policy, but it differs from others by addressing its incentives to *all* highway users, not just a fraction of them. For example, parking controls discourage trips ending in the area but not through trips. Employer-based ridesharing programs target commuters, but not people traveling to school, shopping, or social activities. Unlike most demand-side policies, congestion pricing will promote a wide variety of alternatives to peak-hour driving, leaving the traveler to decide which is best. Of course, alert suppliers should be permitted to

add or expand services where called for so that the number of alternatives actually available is as large as possible.

Two characteristics are essential to congestion pricing. First, tolls must vary widely by time of day, so that only peak travel is discouraged. Second, the peak price must be high enough to make serious inroads into peak demand and thus reduce congestion measurably. It is these traits that make congestion pricing a policy narrowly targeted at reducing congestion, which in turn makes it more likely to succeed.

Congestion pricing is one of a broader array of policies, known as *road pricing*, that use fees to influence travel behavior. Road pricing, which also includes conventional toll roads, fuel taxes, parking fees, and other financial incentives to reduce road use, may be aimed at a number of goals, such as infrastructure finance, environmental protection, historic preservation, and neighborhood revitalization. It is important to keep these goals distinct. Although congestion pricing can have beneficial effects on these other goals, and, conversely, other forms of road pricing can reduce congestion slightly, no single policy can be expected to succeed on all fronts. A combination is in order to accomplish that.

The Infrastructure Connection

In its 1991 federal highway reauthorization bill, Congress agreed to spend \$150 million for up to five congestion-pricing demonstration projects. (Proposals for 16 cities have now been received.) The bill was passed by a Democratic Congress and crafted in considerable part by a Democratic senator, Daniel Patrick Moynihan. Still, there is no doubt that the market orientation of the Republican administrations of the 1980s was important to the emergence of policies such as congestion pricing. Can the idea, whose most direct political appeal is to high-income people who greatly value their time, survive a more liberal administration?

Current politics suggests an intriguing answer. Congestion pricing could provide President Clinton just the key he needs to keep his pledge of costly infrastructure improvements. How? By pointing the way to increasing the efficiency of U.S. infrastructure investment.

For example, a large American city, facing growing congestion in its suburbs, proposes building a new freeway. Engineers calculate that eight lanes are needed to cope with immediate demand and foreseeable traffic growth. But a road that large is costly, consumes valuable land, and has adverse effects on the environment and on the quality of residential life—and thus poses problems for local and federal sponsors alike.

Suppose, however, that the federal government conditions its financial assistance on the requirement that the new road be paid for in part by “peak-hour user fees” that will discourage some traffic and spread the rest more evenly over the day. Under those conditions, the highway needs only six lanes. Such a requirement for federal cost sharing, then, has double merit: it reduces capital requirements as well as adverse environmental and land-use impacts. These are just the ingredients that could make possible a political

compromise while conserving federal and local financial resources.

It may be objected that the smaller road would not relieve as much congestion on parallel routes as would the originally planned eight-lane road. True. But it might still relieve enough to form a satisfactory compromise, and it might also provide funds to improve the parallel routes. And we can go one step further. Suppose congestion pricing is instituted on those routes too—admittedly a much greater political challenge. Such a move would not only bring in more money for other infrastructure improvements such as bridge replacements or new transit systems, but would also reduce the pressure on those older roads and thereby postpone the time when they might need to be widened or repaired. Congestion would be relieved, investment requirements reduced, and financial resources increased.

Economists’ dreams can be politicians’ nightmares, and “congestion pricing” is no exception. Charging people for what has been free is no more popular in the United States than it is in Russia.

Looked at this way, congestion pricing exemplifies a broader argument about infrastructure policy. The infrastructure question should not be framed simply as “how much should we spend?” but as “how can we improve the efficiency of that investment so we can afford it?” Better design of user fees for a host of infrastructure components, ranging from airport runways to water reservoirs, can make limited federal, state, and local dollars go further in shoring up our infrastructure.

High-Tech Toll Collection

In the long run technology will drive policy and make some form of congestion pricing almost a certainty. Electronic road pricing has been thoroughly tested in Hong Kong and is now used on many toll roads in the United States and elsewhere. Its widespread adoption for prosaic toll collection is already guaranteed. For

example, toll authorities in New York, New Jersey, and Pennsylvania have agreed to develop common technology for optional electronic toll collection, which will result in millions of cars being equipped with devices that simplify toll payments—either through monthly bills or by deductions from prepaid magnetic cards (similar to modern transit fare cards).

From there, it is an easy technical step to collect tolls that are differentiated by time of day. In Oslo, Norway, for example, collection stations for a toll ring around the inner city, which opened in 1990, were designed with this capability in mind for possible future use. Closer to home, a road pricing system now in place at Los Angeles Airport for service vehicles could easily be adapted to incorporate differentials between peak and off-peak traffic.

Inevitably the potential of time-varying tolls to increase revenues and reduce infrastructure requirements

and certainly not in the ideal form economists propose, but enough to begin to change the nature of urban transportation.

Beginning to Look Ahead

What would happen if congestion pricing were to become truly widespread? The most immediate and important change would, of course, be less congestion. Both in Singapore and outside Paris congestion pricing has flattened severe peaks in travel volumes. If pricing were widespread, the resulting time savings, valued at tens of millions of dollars a year in any large city, would provide important economic advantages. (Depending on how fees are set, there may be some offsetting increases in congestion just outside the peak periods or the geographical area in which the higher fees apply.)

People's broader responses to the targeted fees are more difficult to predict. The value of property whose accessibility is improved would increase at the expense of property that becomes more costly to reach. Relative wages for jobs with changed access would also shift, offsetting some of the immediate financial effects of the fees themselves. As people shifted to other travel arrangements, the nature of transportation services themselves would change. Carpools would be easier to arrange because more people would be trying to form them. Transit systems would be used more widely, requiring increased service that should make transit more convenient. Less congested city streets would increase both labor productivity and service quality for buses or streetcars.

As people weighed commuting time and costs in making their housing choices, they would find the balance shifting further toward short commutes, at least in areas where congestion charges apply. The ultimate result could be greater residential centralization or greater job decentralization, both of which are goals now pursued through cumbersome land-use controls. A change that could take place more quickly is a drop in the large amount of "cross-hauling" in American cities. Congestion pricing would give people who are moving anyway (because of a job or family change, for example) more reason to shorten commutes, thus reducing the number of people who live considerably farther away from their jobs than the availability of suitable housing requires.

Reducing peak-hour congestion would tend to improve air pollution both by reducing total daily traffic on existing highways and by eliminating the higher emissions rates that characterize congestion. Off-peak travel, however, would probably increase and thus offset some of those gains. As noted, congestion pricing is not the most direct way to address air pollution and should not be judged primarily by its environmental benefits.

Like any price change, congestion pricing could have significant effects on the distribution of real incomes. Although the complexity of shifts in labor, housing, and land markets makes these effects hard to predict, the direct effects would hit relatively hardest at low-income people. Not only does road use rise less than proportionally with income, but also time savings

Table 1. A Package of Revenue Uses for the Los Angeles Region

	MILLIONS OF 1990 DOLLARS
	ANNUAL AMOUNT
REIMBURSEMENTS TO TRAVELERS	
Employee commuting allowance (\$10 a month)	\$ 695
Fuel tax reduction (5¢ a gallon)	350
GENERAL TAX REDUCTIONS	
Sales tax reduction (½ of transportation surcharge)	525
Property tax rebate (eliminate local highway subsidy)	465
NEW TRANSPORTATION SERVICES	
Highway improvements	315
Transit improvements	310
Services in business centers	320
TOTAL (NET REVENUE)	\$ 2,980
COLLECTION COSTS	140
TOTAL (GROSS REVENUE)	\$ 3,120

Source: Author's estimates, based on data from the U.S. Federal Highway Administration, California Department of Transportation, and California State Board of Equalization. For details see Kenneth A. Small, "Using the Revenues from Congestion Pricing," forthcoming in *Transportation*, 1993.

will lead to experimentation. Suppose a toll road is proposed parallel to a congested free road, but construction financing is questionable. With a constant all-day toll rate, setting the rate too high could cause most off-peak traffic to use the parallel free road, making it impossible to raise enough revenue. But if the toll can be differentiated by time of day, the rate during peak hours can be adjusted to limit traffic just enough to maintain a time advantage over the congested free roads while still bringing in plenty of revenue. And off-peak tolls can be kept low enough to maintain patronage and bring in some supplementary revenue.

Where and when such experiments take place will no doubt depend on idiosyncratic political factors. But once people get used to time-differentiated tolls and realize that they promote a smoothly flowing road system, congestion pricing will spread—not everywhere,

are less valuable to low-income than to high-income drivers. That inequity is a significant political barrier to enactment of congestion pricing and must be addressed in designing a policy.

The full distributional effect of congestion pricing, of course, depends on who benefits from the revenues collected by the tolls. If revenues were spent entirely on improving inner cities, the net result would surely be progressive; if spent mainly on services for affluent suburbs, it would be regressive. A plan for using the revenues, then, is an integral and critical component of any congestion-pricing proposal.

Uses of Revenues

Any such plan must be carefully molded if it is to appeal to voters. Surveys and elections from London and California have demonstrated people's willingness to consider taxes or fees as part of an explicit package that includes strongly desired revenue uses.

To illustrate the possibilities, I have outlined a plan to use the revenue from a hypothetical congestion-pricing program for greater Los Angeles that was proposed by the Environmental Defense Fund (EDF) and the Regional Institute of Southern California. Its aim is twofold: to offset the direct adverse effects of the fee payments themselves and to appeal to some key political interest groups.

The EDF proposal is based on a fee structure in which average peak-period fees of 15 cents per vehicle-mile apply to roughly a quarter of the region's traffic. Annual revenues, less collection costs, would be nearly \$3 billion. It is the astounding size of this figure that creates the opportunity to provide significant offsets to the sharp pinch that people paying the fees would feel. For a typical commuter traveling 10 miles each way on congested roads, that pinch would be about \$66 a month—offset, of course, by the time savings.

Revenue would go into three roughly equal packages, summarized in table 1. The first would put money directly back in the hands of frequent users of the transportation system. The second would reduce general taxes now used for transportation. The third would improve transportation services. Thus, all revenue would go to support transportation, either substituting for or supplementing current sources. My proposal leans heavily toward substitution—for two reasons. First, lower peak-period demand would reduce infrastructure needs, so increasing spending by anything like the full amount of the toll collections is likely to be wasteful—better to give some of it back through other means. Second, many citizens will view the new fees as taxes, so may support congestion pricing only if other taxes are reduced. In addition, with revenue of this size at stake, it is crucial to minimize opportunities for powerful groups to appropriate it for uses that do not enhance people's welfare.

The first revenue package, reimbursements to travelers, would include a commuting allowance of \$10 a month, channeled through employers to every worker in the region, and a five-cents-a-gallon cut in fuel taxes. Both would return some congestion-fee revenues to road users—thus easing their unhappiness with the increased cost of getting to work—without

undermining the incentive to curtail solo driving on congested routes. Lowering the fuel tax would emphasize that congestion fees are being substituted for other taxes as a method of highway finance. It would also reduce a regressive tax.

The general tax-reduction package would feature cuts in the sales tax and in the property tax. A dedicated sales-tax surcharge (1 percentage point in Los Angeles County, half a point in most of the rest of the region) now goes to finance regional transportation. Cutting that surcharge in half would lower another regressive tax. It would also emphasize the link between the congestion charges and transportation funding. So would a property tax rebate, which would allow taxpayers to keep the portion of local taxes now spent on highways.

The transportation services package would help the region work off its backlog of unfunded highway projects, improve mass transit service, and target some specific transportation-related services—street improvements, lighting, pedestrian amenities, transit shelters, and so forth—to business centers that are heavily affected by the fees. These targeted services would help offset any tendency for businesses to leave those centers for less heavily priced areas, and thereby prevent the pricing scheme from promoting job loss or urban decay.

Taken together, these programs would provide benefits to a wide cross-section of urban residents and business owners, but would be targeted especially at groups most likely to be hurt by the new fee structure. They would enable most people to benefit from the policy package as a whole and make real progress in solving the region's urban transportation problems.

The Next Steps

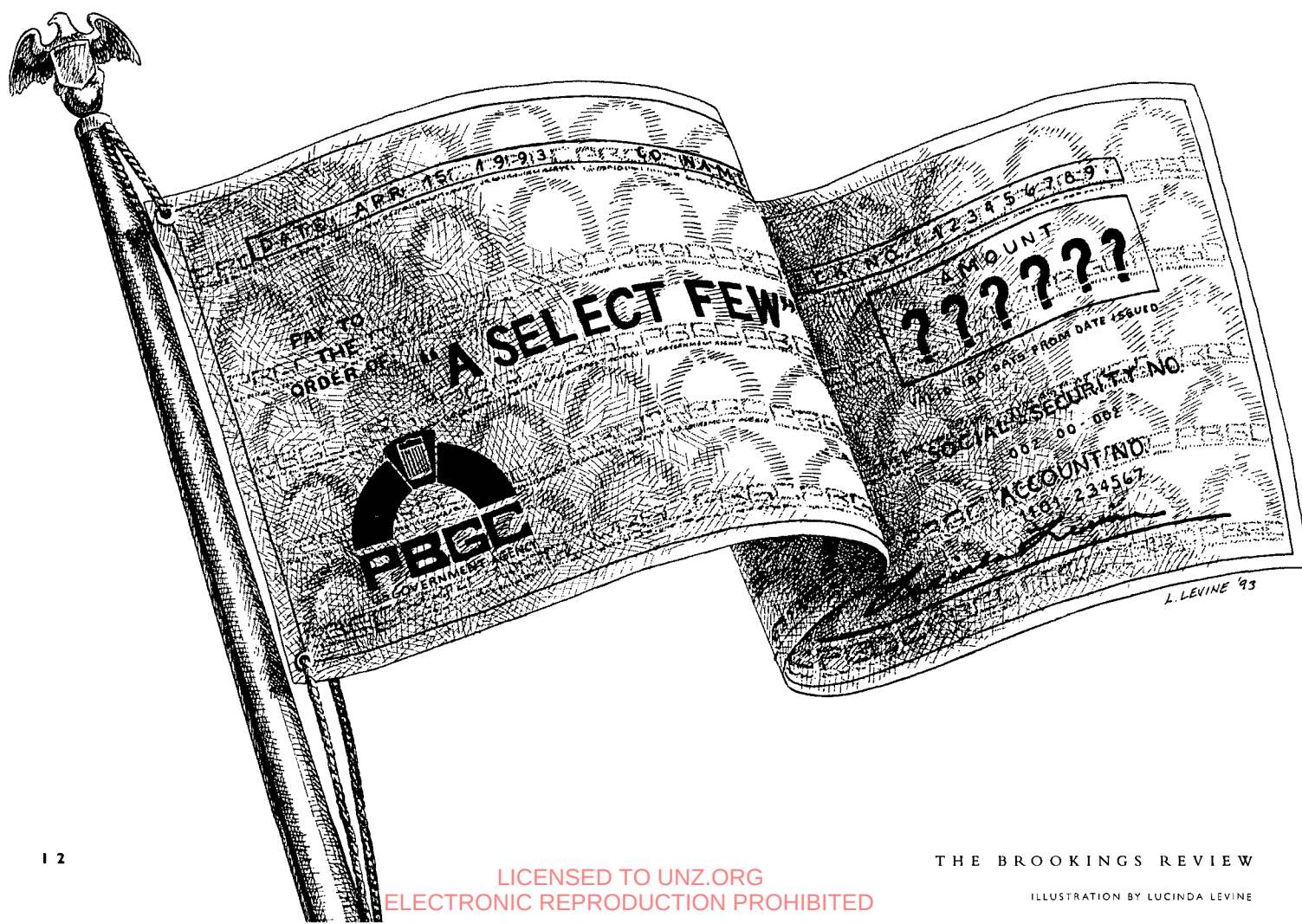
What is the role of congestion pricing in our future? Coupled with intelligent and understandable programs for using the revenues, congestion pricing shows great promise as part of a comprehensive strategy toward urban transportation. Alone among proposed policies, it can bring about dramatic reductions in the severity of congestion while leaving individuals flexibility as to how to respond to its incentives. It also raises money instead of spending it, creating the opportunity to ease fiscal constraints on federal, state, and local governments while providing large and tangible benefits.

This is an ambitious, long-term agenda. For the more immediate future, Congress and the Clinton administration can proceed with three steps. First, they can pursue aggressively the demonstration projects already authorized by Congress, working with local and state authorities to design good projects and helping overcome obstacles. Second, they can expand the demonstration program to accommodate additional projects. Third, they can develop an infrastructure policy that stretches the utility of federal spending by requiring states to demonstrate that each infrastructure element will be used efficiently. If the latter requirement is correctly defined and enforced, pricing will be the only option in many cases. These measures will make a start. If I am right, momentum will carry the day. ■

Avoiding the Next Guaranteed Bailout

REFORMS FOR THE PENSION INSURANCE PROGRAM

JAMES H. SMALHOUT



During the second presidential debate last fall, Bill Clinton responded to a question about the projected bankruptcy of the federal pension guarantee fund by expressing a determination to change the system. "It's not enough just to have a guarantee," he explained. "We had a guarantee on the S&Ls . . . and what happened? You picked up a \$500 billion bill."

He was right. It's not enough just to have a guarantee, and the long-term risks from backing up the private pension system are every bit as serious as what the country has faced—and faces still—from the banks and S&Ls. Taxpayers could be presented with yet another huge bill, this time from the Pension Benefit Guaranty Corporation, an agency originally modeled on federal deposit insurance programs.

Government as we have come to know it—that mother of all insurance agencies—has expanded far beyond the confines of the welfare state. In fact, we now live in what can be more accurately described as a modern insurance state. The purpose of the PBGC and a plethora of other programs like it is the very political, but limited, goal of *shifting* risk. By contrast, real insurance pools risks and charges premiums adequate to cover the cost, both direct and indirect, of the guarantees. Under arrangements like the current pension insurance program, massive obligations can accumulate off the federal budget for decades until the damage becomes just too great. And then taxpayers are forced to pick up the tab.

Never before have worries about the soundness of the PBGC surfaced in a presidential debate. But the issue was bound to grab public attention one day, given the program's increasingly conspicuous defects. And fixing it, even at this relatively early stage, will require far more than the minor tinkering proposed so far.

What Does the PBGC Do?

Ostensibly the PBGC's mission is to provide timely payment of pension benefits when a company goes out of business and, under a limited set of other conditions, terminates a private defined-benefit pension plan that is underfunded. But the program has consequences that go far beyond its stated mission. Most important, it provides a massive subsidy to sick and dying industries, and it tilts the playing field in favor of defined-benefit plans at the expense of other forms of retirement saving (*see box, page 15*).

Since the PBGC was established in 1974, a series of steps have been taken to require firms to shore up poorly funded pension plans. Nevertheless, underfunding has risen to a hefty \$50 billion according to the official estimate. Each year the PBGC publishes a list of the country's 50 most poorly funded pension plans. Just half of these disasters-yet-to-come represent \$15 billion in "probable or reasonably possible" losses to the program. Altogether, the so-called "top 50" now account for unfunded liabilities of \$30 billion, compared with a \$14.2 billion shortfall just two years ago.

So far the agency has taken over more than 1,760

underfunded pension plans covering 336,000 retirees. This year the maximum benefit stands at \$2,420 a month, or \$29,250 a year. Originally, companies paid an annual premium of \$1 per covered worker. Later that premium was increased twice before Congress authorized a "risk-adjusted" supplement in 1988. The total risk-adjusted premium now ranges from \$19 to \$72 per participant. But even at this level it bears little relation to the market value of the guarantee. In reality, federal pension insurance is worth thousands of dollars per participant each year to financially weak companies. This disparity creates a "moral hazard" that encourages riskier investment policies and systematic underfunding of promised benefits.

Even without these other defects, inflation alone is capable of periodically driving the program deeply into the red. Originally, the maximum benefit was set at \$9,000 a year, but it was indexed to rise with inflation by the same factors used for Social Security. For its part, the annual premium had no corresponding indexation feature, and claims under the program quickly exceeded projected revenues.

How much do claims exceed expected revenues? No one knows. Companies are permitted to use actuarial assumptions that greatly understate the cost of retirement benefits, and even the limited information required by the PBGC becomes available only after long delays. Not surprisingly, the agency has discovered that the unfunded liabilities accumulated by terminating plans tend to be much larger than plan sponsors previously reported. But with fewer than 600 people, the PBGC simply lacks the ability to monitor the system.

Every Company Goes Broke Eventually

These problems pale in comparison with the linkage between incentives to fund a defined-benefit pension plan and the product life cycle affecting the sponsor's core businesses. Companies are known to use their defined-benefit plans for building up "financial slack" in the form of surplus pension assets when they are profitable and their principal product markets are healthy. But those same sponsors can then be expected to draw down that financial slack and intentionally underfund their pension plans when the firm enters a period of decline. As Schumpeter taught, capitalism is an evolutionary process of creative destruction. Today's firms will either fall by the wayside or transform themselves beyond recognition. Therein lies the program's most serious weakness.

Federal pension insurance reinforces firms' incentive to underfund a pension plan because workers place much greater faith in otherwise hollow pension promises when the U.S. Treasury stands behind them. Systematic underfunding has been particularly noticeable in collectively bargained pension plans, in which pension benefits are renegotiated upward roughly every three years. Although these increases are predictable, under current law they cannot be funded in advance and are not reflected beforehand in the sponsor's financial reports.

PBGC officials believe that the agency insures some 67,000 plans covering 32 million workers. But coverage is not entitlement because people who work for a firm

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sponsoring one of those plans must be covered for at least five years before earning the right to receive any benefits. As of 1988 only 29 percent of the private-sector labor force had received the right to a pension benefit of any sort. Of these workers, an unknown but sizable share was covered by defined-contribution plans not insured by the PBGC.

The value of the backup guarantee to individual participants is directly related to the vested benefits that they have accumulated in one or more pension plans. Workers generally hold the most pension wealth as they approach retirement age or during the period shortly after retirement. In a typical plan, the value of accumulated benefits rises quickly after the age of 50 with salary increases and additional accruals based on length of service. Based on these factors as well as recent trends in earnings and pension coverage, it is possible to describe the type of worker most likely to gain significantly from the program. More often than not, the worker is male, over 50, working in a relatively high-paying job for an employer he has served for a long time, and living somewhere in the North Central or Northeastern part of the country. Well under a third of all workers actually covered by PBGC-insured pension plans can expect ever to have significant guaranteed benefits.

Recently the PBGC predicted that its accumulated deficit of \$2.7 billion could reach \$18 billion by 1997 without new reforms. But even this projection fails to reflect the program's true cost. The overwhelming proportion of benefits now guaranteed under the program will be paid on time without any loss to the insurance fund. But in such cases, the guarantee can still be quite valuable because a government agency absorbs the risk of default. For the guarantor, such risk-bearing involves indirect and opportunity costs quite apart from actual claims on the insurance fund.

The Bush Administration Approach

As recently as November 1991, the Bush administration gave Congress a four-part PBGC reform package: tougher funding requirements for sponsors, a cap on the guarantee, bankruptcy law changes, and accrual accounting for the program in the federal budget. Despite the merits of accrual budgeting, Congress correctly turned thumbs down on the proposal.

Requiring sponsors to contribute more to their underfunded plans would have worsened the business outlook for many struggling companies. And it also would have *increased* the gap between the value of PBGC insurance and the premiums being charged. When additional pension contributions are financed with corporate debt, the probability of bankruptcy increases. If those contributions are then used to buy stocks instead of bonds, the riskiness of the plan-sponsor combination also increases. For their part, sponsors of poorly funded pension plans are known to prefer riskier portfolio strategies.

The Bush proposal to limit the guarantee to previously accrued benefits of underfunded plans would have led to an inevitable buildup of large unfunded and uninsured liabilities. Ironically, this would probably have presented us with the very problem the PBGC

was created to avoid—terrible inequities in winding up underfunded pension plans. In the 1964 Studebaker bankruptcy and many others like it, plan participants over the age of 60 emerged completely unscathed while many younger workers lost all their promised retirement benefits. Returning to those conditions probably could not be sustained politically over a period long enough to produce the advertised savings.

Finally, the Bush administration wanted to assign the PBGC's bankruptcy claims a higher priority in the hope that the agency would recover more assets following actual plan terminations. But these additional recoveries would have come at the expense of other creditors (for example, banks), with some of their losses then being absorbed by the government either through reduced tax revenues or under other programs such as deposit insurance.

Breaking the Tradition of Myopia

Over the program's entire history, none of the so-called reforms passed by Congress was intended to bring premiums into line with the value of the insurance. As for the future, continuing to ignore this source of instability will only increase PBGC deficits. However, premiums never could be raised to reflect the true value of this insurance. At that level, a risk-based premium would quickly force huge numbers of companies to liquidate. And a premium that shifted all risk to other sponsors, instead of taxpayers, would cause healthy plans to exit the defined-benefit system. The only practical alternatives are to reduce insurance values or acquiesce to a massive bailout.

Unfortunately, this trade-off was overlooked during congressional hearings in February. Those hearings focused on legislation introduced by Rep. Jake Pickle requiring most companies to fund benefit increases in advance and to meet more stringent funding rules. Plans that failed to meet the new standards would lose the exemption that protects investment income and capital gains from the corporate income tax. Although Pickle's proposal will not solve the PBGC's problems, he has performed a valuable public service by calling wider attention to this issue.

When President Clinton scrutinizes this program, he would do well to start with first principles. Government cannot intervene with a massive financial guarantee to protect one group from risk without exposing others to even greater risks. The challenge facing policymakers is to create an environment in which expectations coincide with the ability of sponsors to support their retirement promises. When companies deliberately build up pension obligations that they cannot afford, workers should not expect a handout from the rest of the population. The PBGC currently does not guarantee all benefits promised irresponsibly, and even some guaranteed benefits can be excessive. Yet, complaints about benefit reductions receive sympathy. Objectives for the program therefore need to be clarified and the PBGC restructured to provide only a minimal safety net designed, with social security, to keep the elderly out of poverty.

The operative policy goal during this period of declining real incomes and pension coverage will be to

provide basic benefits to a greater number of people. Returning to the old bankruptcy rules would not serve that purpose. Nor would continuing to insure relatively high levels of retirement income for an elite group within the elderly population. Nor—most emphatically—would transferring the large costs of this program to taxpayers serve that purpose either when other, more urgent needs are going unmet.

Three tools are available to President Clinton that, if used together, would stop companies from making pension promises that could only be kept at the expense of the insurance fund and eventually the American taxpayer. The first of these tools is a stop-loss mechanism. Unreasonable risks to the insurance fund can be avoided if pension liabilities are frozen when asset values become inadequate to cover them. Pension liabilities, however, are imprecise and can be estimated only within a wide range of probability. The controversy that would surround virtually any reasonable set of actuarial assumptions used to estimate these obligations would make it difficult, if not impossible to implement this measure alone.

Working along with the stop-loss mechanism would be the second tool, a market-based solvency test that would require security in the form of a backup guarantee from private insurance companies or other financial institutions. If the combined creditworthiness of the pension plan and its sponsor was so weak that pension insurance could be not be obtained, then benefits would be frozen. By relying on the collective financial and actuarial judgments of the insurance industry among others, this approach would relieve public officials of the responsibility—one they have not been able to perform effectively—for defining precise funding standards. However, the government would take on the new responsibility of monitoring the financial strength of private guarantors to ensure that promised retirement benefits are paid.

Finally, guaranteed benefits should be reduced. Implicit in this approach is an assumption that the program is too generous. In addition to maximum guaranteed private pension benefits of \$29,250 a year, the government provides social security payments up to \$13,500 a year. Scaling back the PBGC guarantee to \$8,000 a year would represent a big step in restoring equity between participants in defined-benefit plans and the rest of the labor force. For his part, President Clinton probably does not believe that the U.S. government should guarantee incomes of \$42,750 a year when he actually earned less than that last year as governor of Arkansas.

Taken together, these three measures would produce a *triage* system for defined-benefit pension plans. A first group of healthy plans would immediately exit the government-run program to enter new private insurance arrangements. Among the advantages for these plans would be less onerous regulatory burdens and probably lower premiums as well. Meanwhile, a second group of less healthy plans would be unable to get a private backup guarantee immediately. After a “liability holiday” during which benefits would be frozen, these plans would then become creditworthy enough to enter the private system. Finally, the third group

THE LANGUAGE OF PENSIONS

A **defined-benefit pension plan** is a legal entity separate from the sponsor but funded by that sponsor. The plan makes payments to retired workers based on their previous earnings and length of service. There is no direct link between contributions made on behalf of workers and their retirement benefits.

A **defined-contribution pension plan** resembles an individual retirement account (IRA) or tax-exempt savings account. It promises only the initial contributions plus subsequent investment returns.

Pension liabilities represent actuarial reserves for the estimated present value of benefits promised to workers.

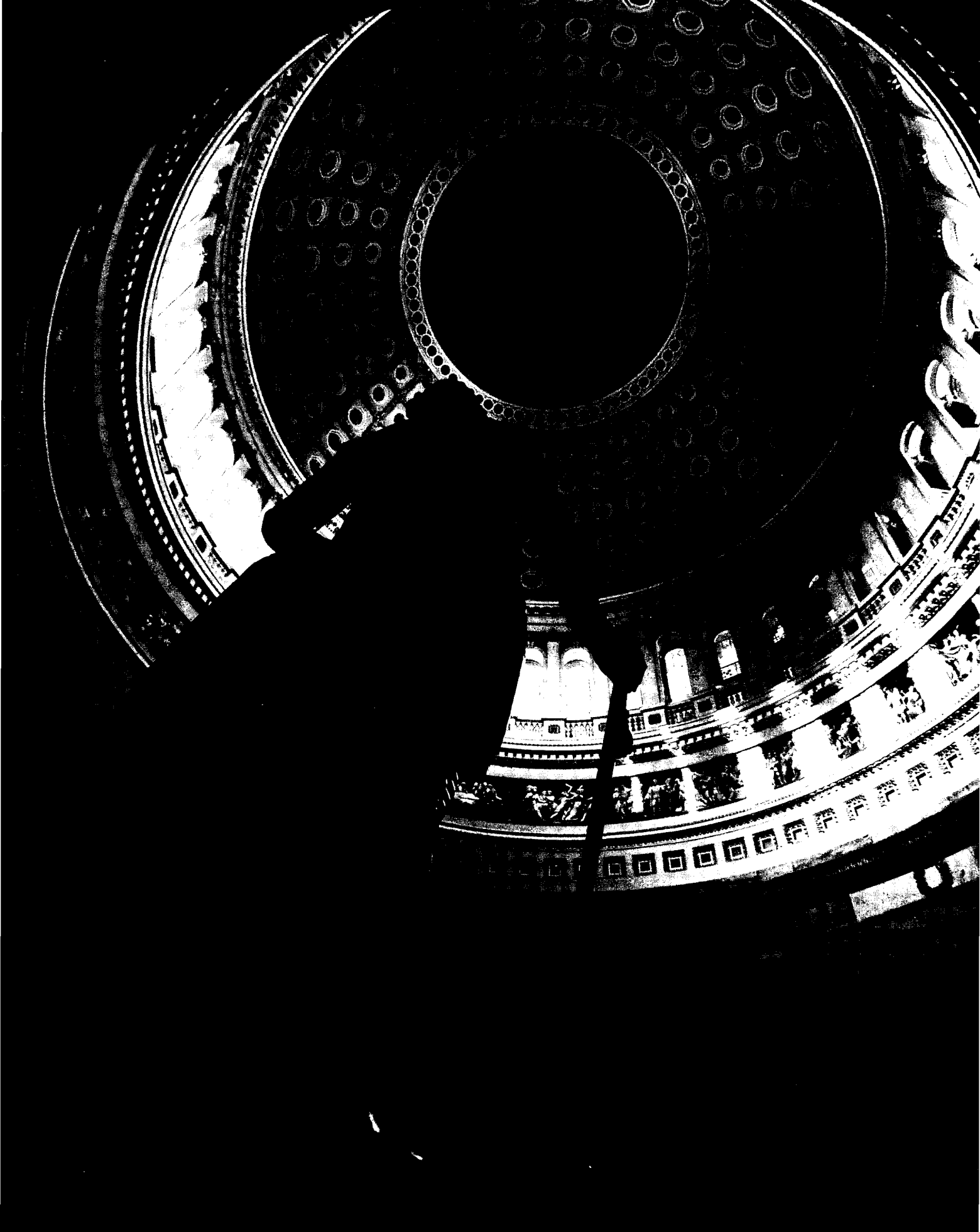
Vested benefits are entitlements that workers retain in the event that their employment by the sponsor should end.

The **pension “put”** is the option retained by the plan sponsor to transfer an unfunded pension liability to some other party upon liquidation of the firm. This put option has positive value to the sponsor. Before Congress established the PBGC, unfunded liabilities were “put” to certain groups of plan participants. Today they are put to the PBGC.

could never be expected to satisfy a market-based solvency test. For plans in this group, the approach outlined here would amount to a “termination without termination.” Although the PBGC would not actually trustee these plans before the sponsor liquidated, benefits would remain frozen permanently. Contributions could continue at past levels while the maximum guaranteed benefit would be scaled back in stages.

Recipe for Disaster

Another alternative—which will be extremely attractive to members of Congress up for reelection in 1994—would be to do nothing. With no major bailout of the agency expected before then, the need to confront powerful special interests can be delayed. Doing nothing, however, amounts to an S&L forbearance model, and its shortcomings could become apparent later in the first Clinton term. By then it would be too late for major legislation, and incumbents could claim no political credit for solving the problem. Hesitation and a failure to act might even become a political liability. No doubt Bill Clinton will recognize this approach for what it is: a carbon copy of the Bush administration’s script. ■



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STOPPING THE BUCK HERE

THE CASE FOR CAMPAIGN SPENDING LIMITS

Everybody—the public, members of Congress, campaign contributors, and, as always, Common Cause—seems to be dissatisfied with the way congressional campaigns are financed. The call for change is loud and steady. Campaign finance reform is such a prominent issue that all three presidential candidates featured it conspicuously in their campaigns last fall. Now that the days of gridlock are over and Democrats control both Congress and the presidency, supporters of reform are optimistic that this year something will actually get done.

The problem is what to do. Incumbents complain that the current system transforms them from legislators into fundraisers who constantly hunt for money out of the fear that their next opponent will be well-financed. Challengers have a different grievance: they claim that the system is stacked against them in that it allows incumbents to raise funds far more easily than they can. The image of politicians' endless chase for money, fueled by the inevitable articles about this PAC or that, makes an already cynical public even more critical of Congress. The charge that members trade votes for contributions, however exaggerated, remains a serious concern.

There is a partisan twist to this issue, too. Because Democrats and Republicans raise money from different sources, any change in policy might affect one party more than the other. As a result, beyond agreeing that the existing system is a mess, Democrats and Republicans see eye to eye on little else. Republicans favor party campaign committees and individual contributors. Democrats want to preserve political action committees' and labor unions' role. But the fiercest point of contention is whether to slow the money chase by setting limits on the amount candidates can spend on their campaigns.

Democrats have long maintained that spending ceilings are an essential part of any campaign finance reform package. They claim that limits will both free candidates from the demands of constant fundraising and reduce the influence of monied interests. Repub-

Jonathan S. Krasno, assistant professor in the Department of Politics at Princeton University, recently completed a book on congressional campaigns and elections. Donald Philip Green, associate professor in the Department of Political Science at Yale University, is writing a book on self-interest in democratic politics. They have collaborated on a series of articles on campaign spending and House elections appearing in the American Journal of Political Science and the Journal of Politics.

licans are viscerally opposed to spending limits, which they regard as a Democratic ploy that will guarantee the reelection of incumbents and, not coincidentally, a continued Democratic majority in Congress. That belief has derailed campaign finance legislation in the past, and it may prove strong enough to do it again in the current, 103rd Congress.

Last year a far-reaching campaign finance reform bill that included limits on campaign spending passed both the House and the Senate, only to be vetoed by George Bush. With Bill Clinton in the White House, the outlook for enactment will be different. But there is nothing automatic about the bill's prospects. Recent foot-dragging by the Democratic leadership suggests that some members who supported it last year did so knowing that Bush would veto it. The large turnover on Capitol Hill as a result of last fall's elections is another question mark.

The biggest hurdle for campaign reform this year, as in the past, will be the Republicans' conviction—buttressed by the preponderance of academic analysis—that a bill with spending limits is a virtual Incumbent Protection Act. But that view, which for years has stood in the way of campaign finance reform, is simply mistaken. Spending limits will *not* harm challengers' chances or make congressional elections less competitive.

The Republican Case for Unlimited Spending

The case against spending limits, no matter who is making it, starts with the image of the almost invulnerable incumbent. And it is a fact that incumbents rarely lose—in the past 10 years, for example, more than 95 percent of House incumbents have won reelection. Among the reasons why are the familiar perquisites of office like the franking privilege, which allows incumbents to flood their constituents' mailboxes with self-serving missives, and the casework incumbents do to cut through government red tape and secure services for their constituents.

The result is an incumbent advantage in voter fa-

miliarity, approval, and even affection that is extremely difficult for challengers to overcome. That's where Republicans believe that money comes in. To defeat entrenched incumbents, they reason, challengers must outspend them. In fact, challengers must spend every dollar they can if they are to have any hope of overcoming their political handicap.

Are the Republicans right? Our analysis examines the impact of campaign spending and spending limits in 1,540 House races from 1976 to 1990. This set of races includes each contest in which an incumbent was opposed by a major party challenger in that particular election *and* in the previous election (we excluded 1982 because of redistricting). We focused our attention on these districts because our statistical analysis relies on historical voting patterns. (Because spending patterns in Senate elections vary so much as a result of population differences among states, we concentrate on House races, but ongoing research on Senate elections points to the same conclusions.)

As it turns out, money *is* essential for challengers, but they do not necessarily have to spend more of it than incumbents do. Winning challengers spent almost four times more money than the average challenger (\$490,000, as compared with \$130,000 in 1990 dollars). But among the 66 challengers who won (4.3 percent of the sample), fewer than half (46 percent) managed to outdo the incumbent. Republican conventional wisdom to the contrary, outspending incumbents does not seem to be essential for challengers.

What about all those challengers who lost? They usually ended up swamped in a sea of incumbent dollars. Incumbents outspent challengers by an average of more than \$200,000. Designing a policy to protect the rights of the handful of challengers able to raise and spend more money than incumbents ignores the overwhelming majority of challengers who now cannot hope to raise money on that scale. If the Republican goal is to enhance competition, that is not the way to do it. Of course, one may hold out for some sort of system that will help challengers raise more money than incumbents. But hard as it is to imagine how that might be accomplished given the fund-raising advantages that come naturally to incumbents, it is even harder to imagine congressional incumbents passing a law to do it.

The Academic Argument

Opposition to campaign spending limits is not confined to Republicans. Academic analysts of campaign finance, led by Gary Jacobson of the University of California at San Diego, agree that spending limits would curtail challengers' ability to defeat incumbents. Jacobson has estimated the effects of campaign spending on election results using a model in which the vote is determined by four factors: incumbent spending, challenger spending, the challenger's percentage of votes in the past election, and national tides favoring one party or the other.

One of Jacobson's chief findings is that spending by incumbents has virtually no effect on the results. How can that be? The answer goes back to the image of the invulnerable incumbent. In Jacobson's view, incum-

bents' advantage in familiarity works against them as far as the productivity of their spending is concerned. Relatively well known to begin with, incumbents have already purchased, by means of their other activities, the name recognition and favorable opinion that campaign dollars are meant to buy. By contrast, spending by challengers, who generally begin their campaigns in obscurity, has a substantial effect. As challengers gain prominence, the effect of their spending diminishes. Incumbents basically begin at the point of diminished returns as a result of their other activities.

In such a world, spending limits certainly would adversely affect challengers. Ceilings would restrict the amount they could spend—and the money they spend is the only money that influences the vote. Limits would have no consequences for incumbents, since their spending is essentially wasted.

Let's Try That Again

Jacobson's view, of course, depends on Jacobson's numbers. Our numbers are different. As we see it, the effect of incumbent spending is substantial—in fact, many times larger than Jacobson estimates. Figure 1 shows the return from spending by incumbents and two types of challengers, a politically experienced one and a novice (the most common type of challenger). Both sorts of challengers receive more bang for their buck than incumbents, but incumbents are far from unable to influence election outcomes.

We reached this conclusion by using a model based on Jacobson's pioneering effort. To his model we added a fifth variable, challenger quality, which measures the background characteristics of the challenger, such as political experience or celebrity status, that relate to political success. We also make allowances for the fact that politically experienced challengers are able to spend money more effectively than novices. Indeed, as figure 1 shows, challenger spending turns out to be most productive for high-quality challengers, those with the best product to sell.

Most important, our model solves one longstanding difficulty in accurately measuring the impact of incumbent spending. Incumbents are so good at raising money that they can simply raise and spend more when they feel it is necessary. The point at which they decide to spend more, of course, is the moment they sense that they are in some danger of losing. Thus, incumbents tend to spend more the worse they do—which makes it look as though their big spending has little effect on the election results.

We address the problem by using an incumbent's spending in the previous election as a gauge of his or her ability or taste for fundraising. Some representatives, such as Robert Dornan (R-Calif.) or former member Stephen Solarz (D-N.Y.), are always on the list of top spenders, while William Natcher (D-Ky.) and Andrew Jacobs (D-In.) are always at the bottom. Compared with other members, these incumbents always spend a lot or a little, regardless of the opposition. By taking these tendencies into account, we can correct for that portion of incumbent spending that is a reaction to a surprisingly strong challenger. This adjustment reduces the number of cases in our analy-

sis—as noted earlier—but the result is an estimate of incumbent spending effects that is sizable and sensible. Clearly, incumbent spending *does* influence election results, though, as figure 1 shows, its dollar-for-dollar effect is not as large as that of challenger spending. Our finding may come as no surprise to most incumbents, but it is a break from the accepted view among academics. How does it affect conclusions about the effect of spending limits?

What Would Limits Do?

We can use our model not only to evaluate the effects of campaign spending in past elections, but to simulate what would have happened if spending limits had been introduced. We can, for example, posit a variety of spending ceilings, limit all candidates who spent in excess of the ceilings to those various dollar amounts, and then use our effect estimates to calculate the predicted vote in these 1,540 elections. What we find is that reasonable spending limits would not impair challengers’ ability to win elections.

Our conclusion is such a departure from the conventional wisdom that a few words about its underlying logic are necessary. The essential fact about campaign spending in House elections is that incumbents almost always far outspend challengers. The result is that the *net* impact from incumbent spending is on par with the yield from challenger spending, despite the higher dollar-for-dollar productivity of challenger spending. In other words, when looking at figure 1, it is important to remember that we are not comparing the votes gained by incumbents and challengers at the same level of spending: incumbents usually spend several hundred thousand dollars more. Reasonable limits will aid most challengers by forcing economy on incumbents. Challengers themselves, who do not ordinarily spend beyond most ceilings seriously proposed, will be largely unaffected. To be sure, limits may slightly harm the tiny minority of challengers who can raise money above the spending ceiling, but this small cost is more than offset by improving the chances of other challengers as a result of greater financial parity with incumbents. Moreover, the loss to high-spending challengers is less than one might expect because of the diminishing marginal returns from spending shown in figure 1.

Figure 2 shows how spending limits would affect the vote in House elections. The horizontal gray line marks the predicted vote without limits—the status quo—and the red line is the predicted vote under various spending limits. With a \$50,000 ceiling, the mean challenger vote peaks at 34.6 percent, a small gain in competitiveness over the existing system. But the most striking thing is that the average challenger is so badly outspent that even outlawing *all* campaign spending would be a slight improvement over the current system.

Of course, our concern is not primarily with “average” challengers, since victory remains so far from their grasp, but with challengers who might win. We measured the effect of spending limits on this group (figure 3) by calculating the number of challengers with more than 45 percent of the vote—a point

Figure 1. Vote Gain from Campaign Spending, Incumbents and Challengers

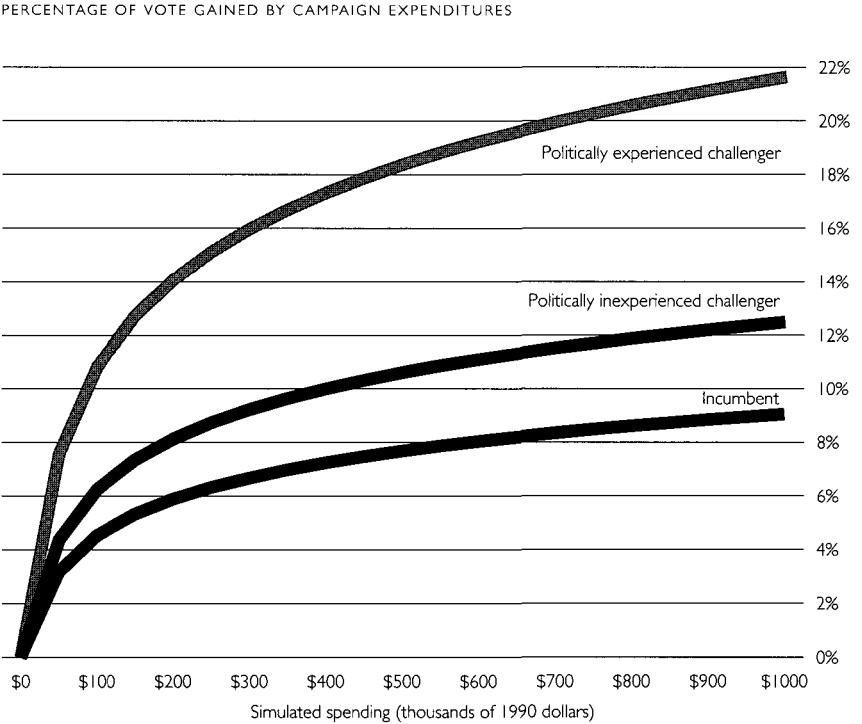
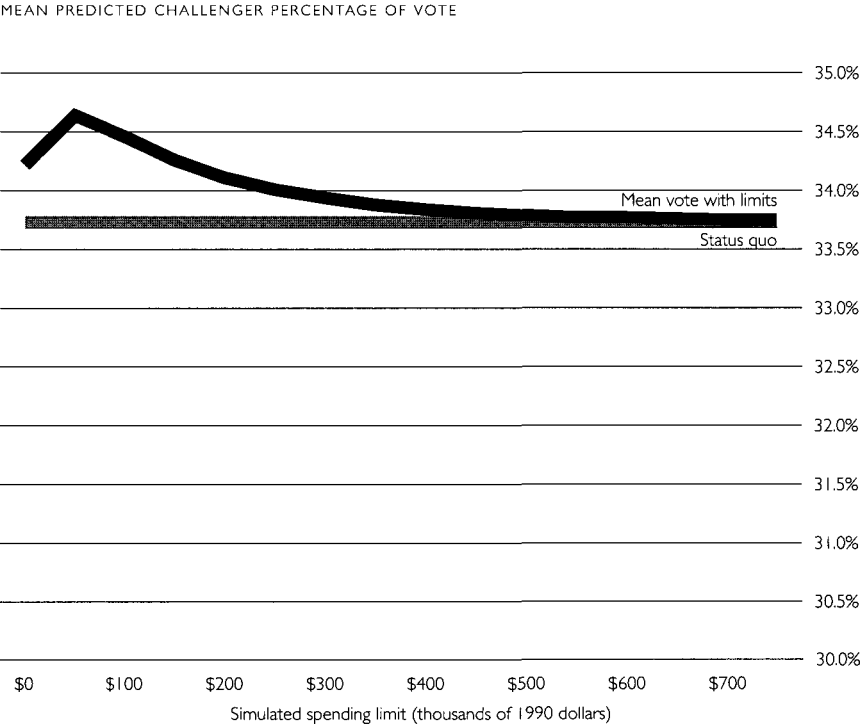


Figure 2. Effect of Spending Limits on Mean Challenger Vote



marking the borderline of a close election—under various ceilings. Here *low* ceilings have adverse effects: limiting spending to less than \$200,000 would reduce the number of close races to the number predicted without limits. However, limits at \$200,000 or more produce as many or slightly more close races. And of the proposals seriously contemplated, none would set ceilings this low and thus none would impair the ability of challengers to compete against incumbents.

In a nutshell, reasonable limits would not make elections less competitive.

The Effect of Public Financing

Because of the 1976 *Buckley v. Valeo* Supreme Court ruling that mandatory campaign spending limits infringe on the right of free speech, spending limits, if enacted, will have to be combined with some sort of public financing to encourage candidates to abide by the limits voluntarily.

What effect does the combination of public subsidies and spending limits have on the prospects for challengers? We tested the impact of three different levels of public financing—outright grants of \$100,000 and matching funds of up to \$100,000 and \$200,000—by adding the appropriate amount to each candidate's spending and calculating their predicted share of the vote. As others have argued, the electoral effect of public funding is unambiguous: challengers benefit enormously. What may be surprising is that sensible spending ceilings have no adverse impact on challengers in such a system.

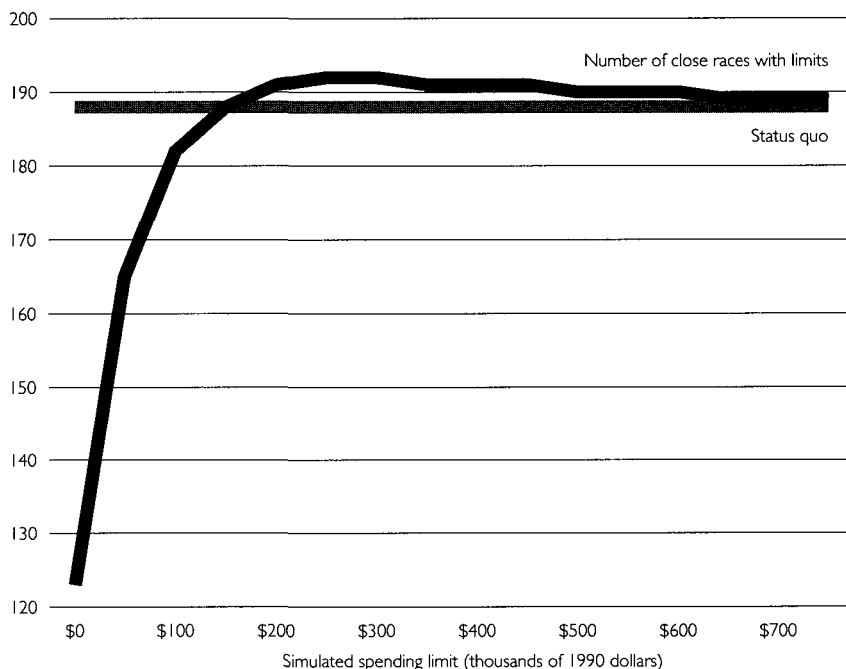
As figure 4 shows, in terms of mean predicted vote, challengers benefit under all three types of public financing. Once again, challenger vote peaks at relatively low spending limits, then gently declines. At the higher levels contemplated by most lawmakers, challengers continue to do better than they do under the status quo.

Our particular interest, again, is with the top echelon of challengers—those who wage closely contested battles with incumbents. Spending subsidies substantially increase the number of serious challengers (figure 5). All the options yield more competitive challengers than the current system. Of course, surpassing the current system is a small feat. What option creates the most competition? The outright grant of \$100,000, by providing seed money for impoverished challenger campaigns, would do the best job. Challengers gain under the other subsidy plans as well. In short, the combination of public financing and reasonable spending limits makes for more competitive elections than does the existing system.

One might still imagine an argument against spending limits based on how they might affect each party. Republicans, after all, are convinced that spending limits will hurt them more than Democrats. To test for partisan differences in the effect of spending limits, we used our model to examine the plan passed by Congress and vetoed by Bush last year—\$600,000 limits coupled with up to \$200,000 in matching funds. As it turns out, both parties' challengers stand to gain from the reform: the number of close races involving Republican challengers increases from 119 to 140; the

Figure 3. Effect of Spending Limits on Number of Close Races

PREDICTED NUMBER OF CLOSE RACES (CHALLENGERS GREATER THAN 45 PERCENT)



number involving Democratic challengers, from 69 to 85. Republicans may seize on that as evidence that such a system offers proportionately greater advantages to Democrats than to Republicans, but the difference is small and might be reversed by linking matching funds to individual contributions only and excluding PACs. In the end, it is clear that both parties' challengers would gain from the combination of spending limits and subsidies. Perhaps we should not write this where House incumbents might read it, but the combination of spending limits and subsidies passed by House incumbents last year would have reduced their chances for reelection.

It is important to stress that our findings probably *underestimate* the beneficial effects of these reforms for challengers. Campaign finance reform that includes public financing may well make it easier for challengers to raise funds from private sources. At the very least, the fact that public financing will help some challengers will inspire potential candidates to oppose incumbents. Currently, just one in seven House challengers has ever held elective office of any kind. Our study shows that not only do experienced candidates look more attractive to voters, they also spend money more effectively.

Toward More Competitive Elections

Insofar as the goal of campaign finance reform is to make elections more competitive, it is clear that reasonable campaign spending limits will not interfere. As usual, the devil is in the details. The cost of campaigning varies considerably across House districts (and far more so, of course, across Senate races). Most House candidates in Los Angeles cannot afford television, and so opt for mail and phone banks. In North Dakota television is relatively inexpensive. Such differences, naturally, could affect the influence of limits. Candidates in expensive districts might need more money than those in districts where it is relatively cheap to run for Congress. But the principles remain the same. Incumbents spend more than challengers, and their spending affects the vote. The financial equality promised by reasonable spending limits remains a step forward for most challengers, whether in Los Angeles or North Dakota. Adjustments might be made to the limits to account for these cost differences, or the public subsidies could be structured to allow candidates to take advantage of the mode of campaigning (television, telephoning, mail) that suits them best. This issue is resolvable.

Such complexities do not alter the fundamental fact revealed by our analysis: spending limits would not hinder challengers' ability to contest House elections. Of course, the best argument for spending limits is based on congressional ethics, not electoral competition. And clearly, public financing would do far more to improve the odds for challengers than spending ceilings. The point is that the conventional wisdom that limits would hinder challengers is wrong. That leaves would-be reformers free to support campaign spending limits on the grounds that they would free candidates from the endless money chase, reduce potential conflicts of interest, and, best of all, help restore public faith in Congress. ■

Figure 4. Effect of Limits and Subsidies on Mean Challenger Vote

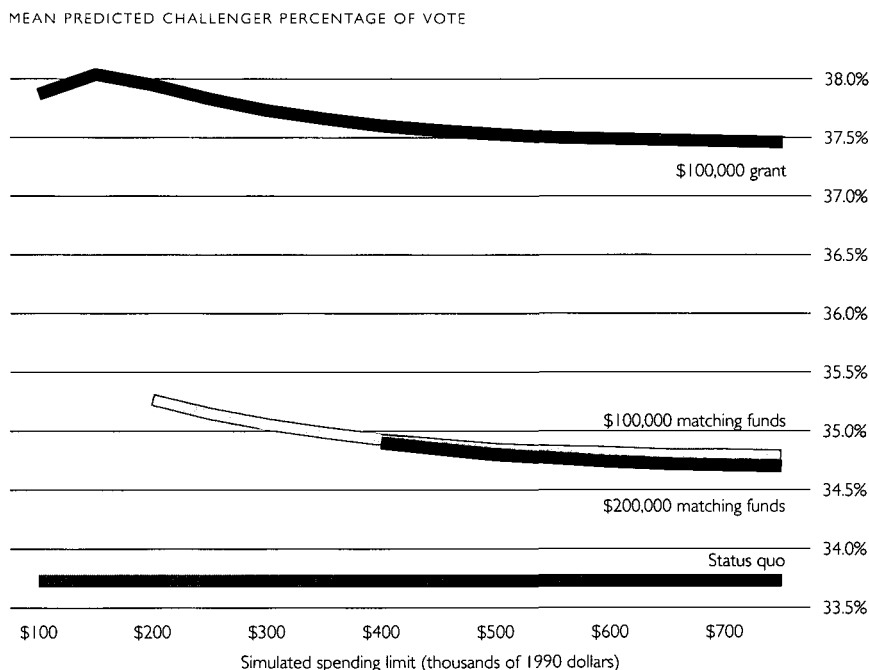
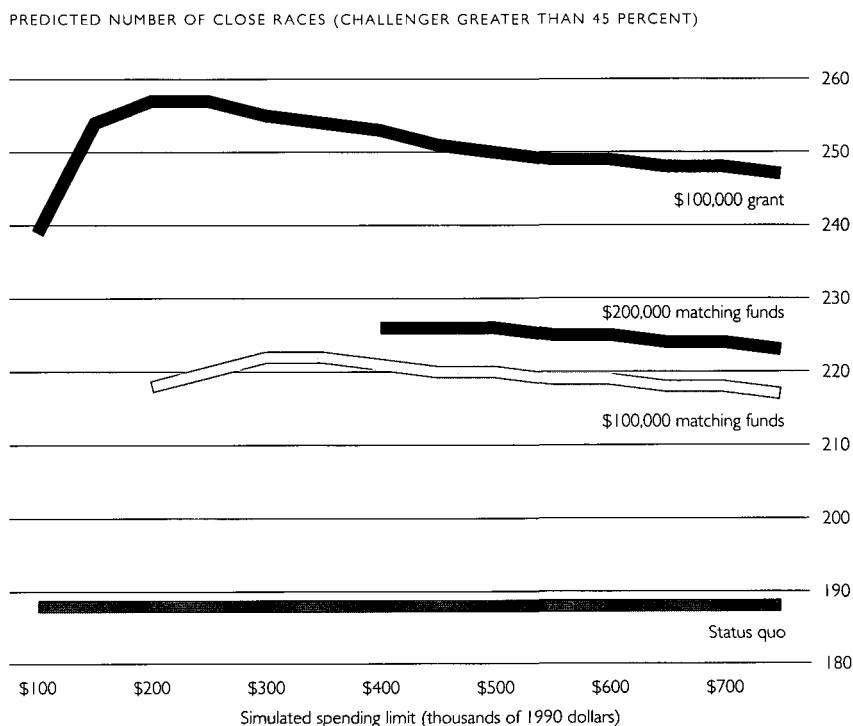


Figure 5. Effect of Limits and Subsidies on Number of Close Races



Joshua M. Wiener and Laurel Hixon Illston

HEALTH CARE REFORM

Six Questions for President Clinton

Joshua M. Wiener and Laurel Hixon Illston are senior fellow and senior research analyst, respectively, in the Brookings Economic Studies program.

Their book, Sharing the Burden: Strategies for Public and Private Long-Term Care Insurance, will be published by Brookings this year.

Health care reform was high on Bill Clinton's agenda during the presidential campaign and is even higher now that he occupies the Oval Office, as evidenced by his quick appointment of a task force headed by Hillary Rodham Clinton, his most trusted adviser. The general direction of his plan "to control costs and cover everybody" is clear. He favors employer-mandated health insurance and cost containment based on managed competition and global budgets. But how will he flesh out the details of his plan? As he grapples with that problem, he must confront six questions.

How Minimum Is the Minimum Benefit Package?

Clinton's plan, like most proposals for health care reform, promises to provide all Americans with access to a "basic benefit package." But what is meant by "basic"?

At one extreme is a bare bones package that will leave major health care needs uncovered and may impose large out-of-pocket costs on consumers. Since most people will want as comprehensive a set of benefits as possible, insurers will tend to compete by designing a benefit package that is attractive to the less-costly healthy population. At the other extreme is the package implied in Clinton's campaign blueprint, *Putting People First*: unlimited hospital care, preventive services, prescription drugs, and more than token amounts of mental health services. That package would be better than the one Medicare now provides to the elderly and better than at least 15 million Americans with insurance now have. It is not politically plausible to give younger people a better minimum benefit package than those over age 65. Upgrading the Medicare benefit package will probably cost between \$15 billion and \$20 billion. In addition, many companies will have to expand their health insurance coverage to include these services, raising their costs.

What Tax Breaks Should Go to Small Businesses?

Even though most small businesses already provide health insurance for their employees, most uninsured Americans work for small businesses that do not. Many work in low-wage or part-time jobs in businesses that cannot afford to pay \$3,000 to \$4,000 a year per employee in health insurance premiums. Clinton has endorsed tax breaks to ease that financial burden, but he has not specified what companies would be eligible, how big a tax benefit they would receive, or whether the tax breaks would be temporary or permanent.

The dilemma is that it is unfair to provide tax breaks only to small businesses that have not heretofore provided health insurance, but extremely expensive to provide them to all companies. Tying the tax breaks to lower-wage companies would create a perverse incentive for companies to hold down wages. For political if not economic reasons, large permanent tax credits are likely to be necessary to quell small businesses' opposition to being required to provide health insurance.

Can Managed Competition Control Costs?

Clinton has made clear that he plans to control costs through *managed competition*, not price controls. The aim of managed competition is to make employees and employers more cost conscious in their choice of insurance coverage. As a result, it is expected that employees will get their health services not from unfettered fee-for-service providers who have no incentive to control costs, but from health maintenance organizations and other forms of managed care — particularly those that do the best job of improving quality and cutting costs. Managed competition clearly fits Clinton's notion that the government should "steer, not row."

Advocates of managed competition believe that changing the tax treatment of health insurance is the key to cost containment. Employer contributions to the cost of health insurance are now an unlimited tax-deductible expense for employers. In addition, they are not counted as income (and are not taxed) for employees, who are thus encouraged to take their compensation in unduly generous health insurance. Most advocates of managed competition would limit this exclusion to the cost of an efficient health insurer providing the basic benefits. People who want to use a less efficient insurer or buy more comprehensive insurance benefits could do so, but they would have to pay income and payroll taxes on the incremental employer contribution toward the cost of the plan.

A tax cap has several policy virtues. It could raise a great deal of revenue, is reasonably progressive in its effects, and would provide more incentives for insurers to control costs. Still, it is unclear that by itself a tax cap could do much to reduce the rate of growth in health spending.

First, employers and employees are already painfully aware that spending is going up—for health care in general and health insurance in particular. According to a 1992 Gallup poll, 72 percent of Americans identify cost as the number one health care problem. Average out-of-pocket health care expenses rose from about \$900 per family in 1980 to about \$2,100 in 1990. Indeed, the soaring cost of insurance is directly responsible for the declining proportion of people covered by employer-sponsored insurance and for the widespread inability of sick and disabled people to buy insurance. Thus, a policy that builds on making people pay more out-of-pocket for health insurance is politically risky, to say the least.

Second, the total federal revenue loss attributable to the tax treatment of employer-provided insurance was only about \$65 billion in 1992. Even if losses can be cut by a third, it seems doubtful that \$22 billion can have a dramatic cost containment effect when overall health care spending for the year was \$838 billion. Furthermore, 45 percent of health expenditures are for government programs that would be exempt, for at least the foreseeable future, from this type of cost competition.

Even if this "excess" health insurance became



taxable, it is unlikely that many people would move from a fee-for-service insurance plan to an HMO. Most people, after all, are in the 15 percent federal income tax bracket. For them, even a \$1,000 increase in taxable income from choosing an “inefficient” insurer or a too-rich benefit package would increase taxes only about \$150. (Social security and Medicare payroll taxes would also increase by about \$75, but some of that would ultimately be returned to the employee in the form of higher retirement benefits.) The sickest 10 percent of the population who are responsible for 70 percent of health expenditures would be particularly unlikely to change insurance.

Although it has not gotten as much attention, a much stronger inducement would be to focus on the employer rather than employee side. If employers could deduct only the cost of efficient health insurance for the basic benefits, they would have a strong incentive not to contribute more than that amount. A worker who faced increased out-of-pocket costs of \$1,000 (rather than \$225 in increased taxes) for choosing an inefficient insurer would be much more likely to change to less costly insurance. But shifting compensation away from fringe benefits and back to income will take time, will conflict with existing collective bargaining agreements, and will not be popular with workers who prefer health benefits over cash even without the tax advantage.

If managed competition is to work, consumers must know which insurers are efficient and which are not. Insurers who provide coverage to older or sicker people will appear to be less efficient than those who enroll only healthy young people, but they must not be penalized for that fact. The key to measuring efficiency accurately is adjusting the employer contributions to account for differential health risk among employees. It is simple to adjust for age and sex, but these are extremely crude variables, and we are not yet able to make the necessary refinements on such a large scale.

How Do Global Budgets Fit In?

“Global budgets”—a new term of art meaning a fixed budget for health care—would force health care providers to live within a budget and end the cost shifting that has thwarted virtually all previous cost containment efforts in this country. For example, hospitals now evade tough Medicare reimbursement rates by charging higher rates to other third parties. Most other industrialized countries, including Canada, France, Germany, and the United Kingdom, control their health care spending through some form of fixed budget and rate setting. All provide near-universal access to basic health services and keep their health care costs, measured by spending per capita and as a percentage of gross domestic product, far below that of the United States.

Although the United States does not have much experience with global budgets, the state of Maryland’s rate-setting system and an early 1980s Rochester, New York, demonstration successfully controlled hospital spending through variations on the global budget approach. And the new Medicare physician reimbursement system sets spending targets—an important com-

ponent in establishing overall budget limits—that are enforced by the threat of future fee cuts. Clinton’s call to integrate global budgets with managed competition is intellectually appealing, but it is not clear how it can be done. The role of rate setting in his plan is ambiguous: it exists as a “fallback,” but not as a central part of his proposal.

Purists say that these regulatory strategies are antithetical to managed competition, the whole point of which is to rely on the market to deliver effective, efficient, affordable care. If prices are set by the government, plans will have far less incentive to compete on price. Managed competition advocates argue that regulatory strategies will end up protecting inefficient insurers and providers by setting rates high enough to sustain them at profitable levels. They also worry that global budgets and rate setting will drain political and intellectual energy from the difficult task of establishing market-based reform.

Finally, to the extent that the avowed goal of managed competition is to promote managed care and prepaid systems, a rate-setting approach may be counterproductive. Health maintenance organizations claim that they cannot convince people to join unless their premiums are at least 15 percent below those of the fee-for-service system. To do that, they say, they must negotiate price discounts from providers, which are likely to be less or nonexistent under an all-payer rate-setting system. But if the only value that managed care is supplying is provider discounts, why use managed care when the discounts can be obtained much more easily and universally by using the power of the government?

It is easy to see how global budgets work in government-run health programs like that of Canada or the United Kingdom, where the government is the sole payer. It is less obvious how they would be enforced in our private health insurance system with hundreds of insurers and thousands of providers. Every year the federal government announces annual health spending, but it is only an estimate and not a dollar-by-dollar accounting of expenditures.

Can national spending be capped and allocated, first among the states and then providers, without congressional logrolling and without institutionalizing existing inefficiencies and inequities? Clinton’s solution is to take the task of setting and allocating the budget out of the hands of politicians and give it to a nonpolitical national health board. The problem is that although budget setting has a technical component, it is not primarily a technical problem. There is no one right or wrong level of health spending. If the health budget is to be societally determined, then it is a political decision in the highest and best sense of the word. It is a decision for which people should be accountable, which means that it must be agreed on by the president and Congress.

While tough rate setting and global budgets would fit with the common public perception that doctors and hospitals are gouging the system with high prices and waste, the political opposition among providers will be intense. Hospitals and physicians favor universal coverage, but oppose regulatory controls. The leader of at least one provider group has raised constitutional issues that could quite possibly delay the plan’s imple-

mentation. President Carter, after all, made hospital rate containment one of his major legislative initiatives and lost.

Will the Savings Be Enough to Cover Everybody?

During the campaign, Clinton argued that health care for the uninsured should be financed through savings in the health care system and that new taxes would not be required. Over the long run, that may be possible, but it will not be easy. Most of the initial savings will accrue to the private sector rather than to government programs. Clinton may be able to argue that some of these savings should be channeled back into health care for the uninsured, but most people will call that a tax increase.

More narrowly, it may still be possible to fund health care for the uninsured through savings in Medicare and Medicaid. If the projected rate of increase in these two programs could be cut by 2 percentage points a year, then by 2000 there may be enough money to take care of the 36 million uninsured. Achieving these savings, though, will be hard because payment rates for both programs are already pretty tough, and upgrading Medicare to meet the minimum benefit package Clinton is likely to propose will take substantial additional funds. Integrating Medicaid into the private insurance system, a long-run goal of Clinton's, will cost at least another \$20–30 billion for payment rate increases alone.

Aside from the ethical question of whether providing basic health care to the uninsured should be held hostage to achieving cost containment, three points argue against this strategy. First, the lesson of other countries is that the sure way to gain control over the health system as a whole is to assure health coverage for everyone. As long as a significant portion of the population has no coverage, cost shifting will allow providers to evade individual insurers' efforts at cost containment.

Second, savings of the size necessary are conceivable only because spending on Medicare and Medicaid—both entitlement programs with ever-expanding participation—is completely out of control and will be adding substantially to the federal budget deficit. If Clinton is to get control of the deficit, he will have to take at least some of these cost savings and apply them to deficit reduction.

Third, managed competition entails a long-run restructuring of the incentives of the health care system. It probably cannot save enough fast enough to provide meaningful coverage for the uninsured during Clinton's first term. Regulatory strategies have a better shot at producing near-term savings, but even that will be difficult.

Where Does Long-Term Care Fit on the Agenda?

Much to his credit, Clinton included long-term care in the list of necessary steps for national health reform. The current system of organizing and financing long-term care imposes catastrophic costs on nearly everyone who uses paid services. Only a trivial portion of total long-term health care bills is now covered by any form of insurance—public or private. In addition, the delivery system is heavily tilted toward nursing home rather than home care. Clinton wants to expand Medicare to cover more of the costs of long-term care, with

a strong emphasis on home care services. But to do so will cost at least \$40–50 billion in new spending, and even ardent supporters of long-term care reforms would agree that health care for the uninsured deserves higher priority. But if a full-fledged long-term care program is excluded from the initial health care reform proposal, how will it be addressed and when?

Two issues may cause Clinton to address long-term care sooner rather than later. First, as indicated earlier, the minimum benefit package for acute care is likely to be substantially more generous than existing Medicare benefits. The catch is that, with the exception of prescription drugs, most elderly already have this expanded coverage through their supplemental private insurance. For them, expanded acute care coverage will not be a

There is no one right or wrong level of health spending. If the health budget is to be societally determined, then it is a political decision in the highest and best sense of the word.

new benefit. It might be better policy, and more politically popular, to put that extra \$15–20 billion into significantly expanding long-term care services under Medicare and Medicaid.

The second issue is whether long-term care will be included in the global budget. Including it will risk institutionalizing the current inadequate system. Excluding it creates strong incentives either to substitute nursing home and home care for hospital services or, less benignly, to reclassify acute care services as long-term care. In either case, long-term care could become a huge escape hatch for the global budget.

No Perfect Answers

Americans universally believe that our health care system is fatally flawed and needs a radical overhaul. There is not, however, much consensus on what should be done. We think President Clinton is on the right track. But his success or failure in pursuing health care reform will largely depend on how he answers these six questions. There are no perfect solutions, only difficult tradeoffs. Whatever answers Clinton develops, he will have to use every ounce of his leadership skills and political savvy to educate the American people on the decisions before us and to push his choices through Congress. ■

ISRAEL AND THE EN

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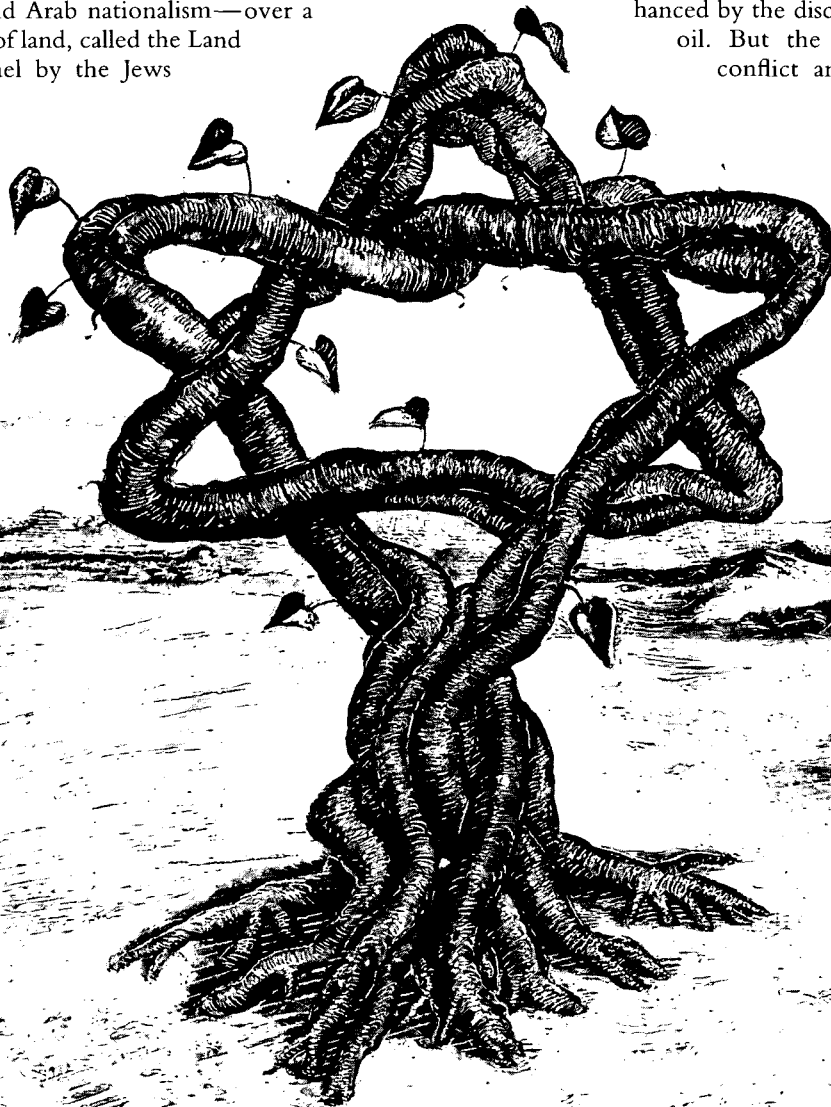
The end of the Cold War and the breakup of the Soviet Union have profoundly affected the Middle East. On the strategic level, the deglobalization of the Arab-Israeli conflict—brought about by the loss of the radical Arab side's Soviet patron—made the current peace negotiations possible. On the cultural level, the reconfiguring of links between Israel and Eastern Europe has refocused attention in Israel on the deep roots of many aspects of Israeli life in Central and Eastern Europe and will have far-reaching effects on the unfolding of Israel's identity and culture. Both developments herald greater stability in the Middle East.

A Regional Dispute Goes Global

In its origins, the Middle East conflict is a dispute between two national movements—Zionism and Arab nationalism—over a piece of land, called the Land of Israel by the Jews

and Falastin (=Palestine) by the Arabs. During the 1950s, however, the regional conflict took on a global dimension with the alliance between the Soviet bloc and radical Arab nationalism, then symbolized by the person, charisma, and ideology of Egypt's President Gamal Abdel Nasser. That alliance, the most dramatic development in the Middle East since the failed Arab attempt to prevent the establishment of Israel in 1947–49, transformed the whole nature of the conflict.

The Nasserist-Soviet alliance was not primarily aimed against Israel. It was based on two common interests of the Soviets and radical Arabs in curtailing Western influence in the region: first, to put an end to the vestiges of British and French influence (as in the case of control over the Suez Canal, as well as French rule in Algeria) and, second, to counter growing American influence, which was greatly enhanced by the discovery and production of oil. But the simmering Arab-Israeli conflict and the unfinished Arab



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agenda regarding the Palestinian question meant that the Arab-Israeli conflict slowly became one of the mainstays of the new alliance.

The supply of Soviet arms to Egypt, Syria, and Iraq (later also to Libya)—together with the easy credits making these purchases possible—enabled the radical Arab states to increase and modernize their armed forces and helped maintain the Arab military elites in political power. It also severely curtailed the military options of the Jewish state in the event of regional war. First, it meant that Israel would have to take into account a possible Soviet response to a military engagement. And, second, it meant that even if Israel defeated the Arabs, Soviet diplomatic support and the resupply of fresh Soviet material would bring the Arab countries to their feet again, as indeed happened time and again in 1956, 1967, and 1973.

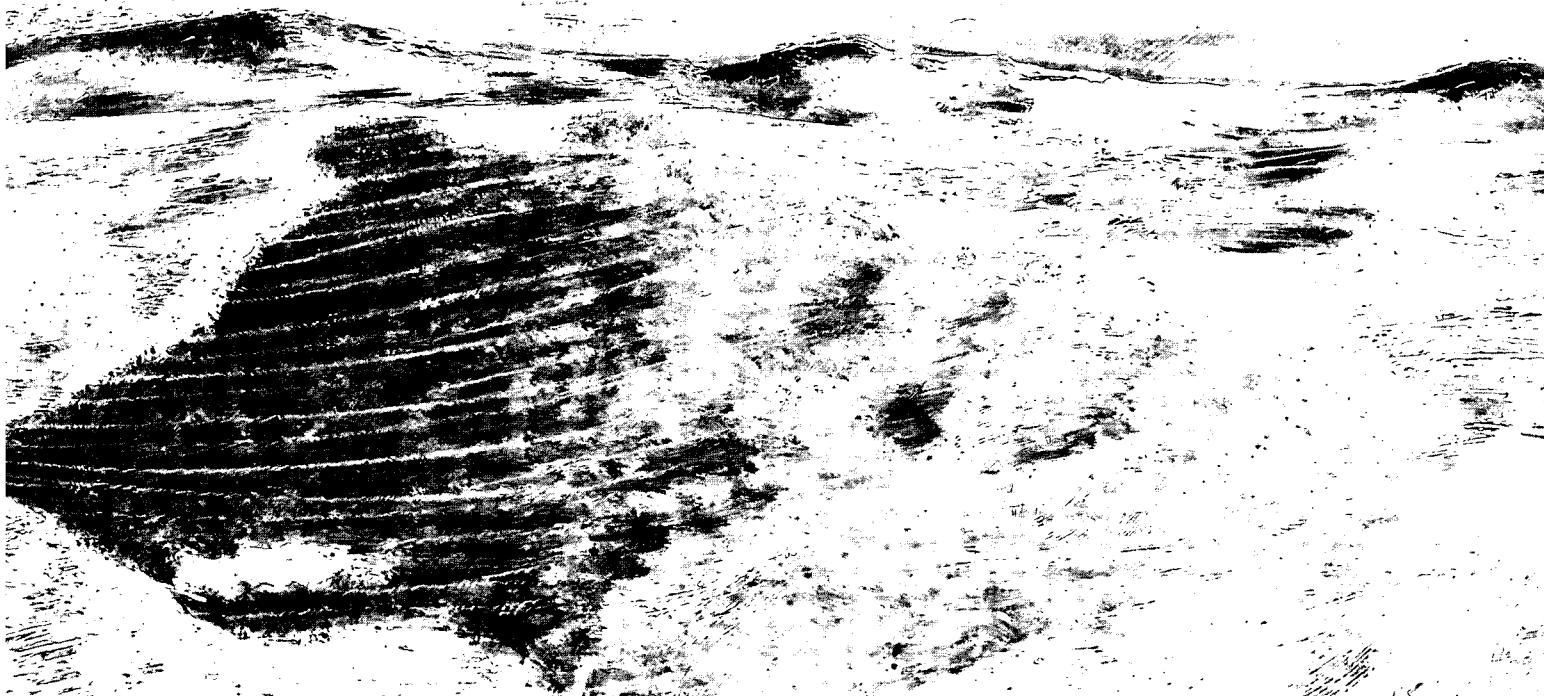
The Soviet decision to sever diplomatic relations with Israel in 1967, shared by all Warsaw Pact countries except Romania, signaled the beginning of a diplo-

matic offensive that for many years put Israel at an international disadvantage. Soviet political, diplomatic, and ideological support for the radical Arab cause also secured for the Arab countries the international context that made it possible for them to keep the Palestinian issue on the world's agenda. It led in the 1970s to the attempt to delegitimize the ideological foundations of Israel through a series of United Nations resolutions equating Zionism with racism. Radical Palestinian factions received training and logistical support from Warsaw Pact countries' security services, which greatly facilitated their terroristic activities not only in the Middle East itself, but in Europe as well. And at least twice, during the War of Attrition along the Suez Canal in the summer of 1970 and then in the last days of the Yom Kippur War in October 1973, Israeli forces found themselves on the verge of a virtual shooting war with Soviet forces. As a matter of fact, in August 1970 Israel shot down a number of MIG aircraft, flown by Soviet pilots, over the Suez Canal.

Shlomo Avineri, of the Hebrew University of Jerusalem, was a guest scholar in the Brookings Foreign Policy Studies Program last summer. He is the author, among other books, of The Making of Modern Zionism.

ILLUSTRATION BY BOB SOULÉ

THE SHADOW HAS FADED



**ONLY WITH THE INTENSIFICATION OF
THE COLD WAR ASPECTS OF THE MIDDLE
EAST CONFLICT DID THE STRATEGIC
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COME TO BE SO CENTRAL AND LEAD TO
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WASHINGTON AND JERUSALEM.**

America Weighs In

The intensification of the Soviet-Arab alliance set in motion an ever-deepening U.S. involvement in support of Israel. Under Presidents Eisenhower and Kennedy, U.S. support for Israel had been lukewarm. Economic assistance was minimal and symbolic, and until the 1967 war, American military aid to Israel was either nonexistent or marginal. But after 1967, with Soviet support for the Arab cause becoming more and more pronounced, U.S. military aid to Israel came to dominate the American-Israeli relationship.

The relationship between the United States and Israel has always been multifaceted, though both its advocates and adversaries usually tend to subsume all its various aspects under one rubric. One aspect is the deep feeling of support across the board in America for Israel as the only democracy in the Middle East; another is the memory of the Holocaust; still another is an undifferentiated yet deep feeling of warmth toward the Holy Land and the people of the Bible; yet another is the political and intellectual influence of the Jewish community in the United States. Only with the intensification of the Cold War aspects of the Middle East conflict did the strategic dimension in the U.S.-Israel relationship come to be so central and lead to the political and strategic intimacy that eventually evolved between Washington and Jerusalem. Although the United States never lost sight of its other Middle Eastern interests and allies, primarily in the Persian Gulf, U.S.-Israel relations developed over the past two decades to the point that Israel was viewed as an American strategic asset—a clear response to the Soviet support of the Arab cause.

The problem of Soviet Jewry—the suppression of the cultural and religious life of Soviet Jews, as well as the ban on Jewish emigration—also helped define the Middle East conflict in Cold War terms. Because the issue had to do with internal Soviet politics, it injected a special note of bitterness, on both sides, into the Soviet-Israeli relationship. The Soviets viewed the call for Jewish emigration as a particularly blatant and even vicious attempt by “the Zionists” to help the United States destabilize the Soviet system, while Israel, and many of its Jewish supporters in the West, saw the suppression of Jewish life in the Soviet Union and the anti-Zionist campaign as verging on antisemitism. For obvious reasons, the issue further cemented the Soviet-Arab alliance.

Naturally, peacemaking in the Middle East became hostage to these Cold War considerations: the peace process itself became a zero-sum game in terms of superpower rivalry. The Soviet Union opposed the Camp David peace accords between Israel and Egypt not because it objected to their details, but because the U.S.-brokered peace agreement greatly enhanced U.S. power in the region and represented a big strategic setback for Soviet influence. Similarly, U.S. objections to the Soviet formula of achieving peace in the area through an international conference, chaired jointly by the United States and the USSR, were motivated by American unwillingness to allow the Soviets a role in peacemaking that would further enhance their influence in the region.

As long as the Cold War lasted, it was extremely unlikely that a meaningful peace process could be initiated and maintained.

After Gorbachev

The changes in the Soviet bloc following the emergence of Mikhail Gorbachev gradually but dramatically transformed the polarized structure of the Middle East conflict. First, some of the Soviet allies in Eastern Europe moved, tentatively and somewhat hesitatingly, toward resuming contact with Israel in the mid- and late 1980s. Then, with the overthrow of communist regimes and the emergence of post-communist governments in the area, Hungary, Poland, Czechoslovakia, Bulgaria, and Albania resumed diplomatic relations with Israel. The Soviet Union itself moved more slowly and sometimes in a zigzag fashion. First, a Soviet consular mission visited Israel, then it applied for a permanent status. At a later stage, an Israeli "diplomatic group" was allowed to operate in Moscow, and the Israeli interest section in the Dutch Embassy was allowed to be staffed with Israeli diplomats. Still later, a Consulate General was established in Tel Aviv. Finally, in the autumn of 1991, full diplomatic relations were established, and, symbolically, if one wishes, on December 23, 1991, one day before the demise of the Soviet Union, the Soviet ambassador presented his credentials to Israel's president in Jerusalem.

On substantive issues, Soviet policy moved step by step with the diplomatic changes over the period of 1988–91. Voices vilifying Israel and Zionism in the Soviet press and in official pronouncements first grew softer and eventually fell silent. Soviet policy toward the Arab-Israeli conflict moved from an uncritical embrace of radical Arab positions to a much more even-handed view, eventually not that different from the position of the European Community and even the United States: support for Israel's existence within secure and recognized borders, resolution of the territorial issue on the basis of direct talks between Israel and the Arab states, opposition to Israeli settlements in the occupied territories, and a solution of the Palestinian question on the basis of Palestinian self-determination. Syria, by that time the Soviet Union's chief remaining ally among the Arab confrontation states, was informed that President Hafiz el-Asad's avowed aim of "strategic parity" with Israel (that is, an offensive capability) would not be supported by Moscow. Soviet military aid to Syria was curtailed, and most Soviet military advisers were withdrawn. The Palestine Liberation Organization was advised to move toward a diplomatic path, and Palestinian terror attacks on Israel were, for the first time, officially condemned by Moscow. The radical Marxist-oriented Palestinian factions were persuaded to support the mainline PLO diplomatic option aimed at reaching a "two-state" solution, a Palestinian state in the West Bank and Gaza *alongside* Israel, not supplanting it. Logistical support of terroristic activities was severely curtailed and eventually shut off—and in any case, much of it stopped with the emergence of post-communist regimes in Poland and Czechoslovakia and the disappearance of East Germany.

Last and not least, Jewish emigration to Israel was allowed, Arab protests notwithstanding, and within the general guiding principles of perestroika, the ban on Jewish cultural and religious activities in the Soviet Union itself was lifted. Some 400,000 Jews emigrated to Israel from the Soviet Union and its successor states between 1989 and 1992.

Opening the Way to Peace

The disappearance of a Soviet umbrella has had a twofold effect on the dynamism of the Middle East conflict. First, it has greatly diminished the military option open to the radical Arab states and tilted the strategic balance perceptibly in Israel's favor. Second, through such developments as the show of Soviet support for the U.S.-led coalition in the Persian Gulf War (despite some disquieting zigzags on the part of Moscow), it has decoupled radical Arab forces from their erstwhile patron. By reassuming its true, regional proportions, the Middle East conflict has made peacemaking much less intractable. The road to Madrid was made possible precisely because there emerged, for the first time since 1956, a common U.S.-USSR agenda, not based on a Cold War zero-sum calculus, with the radical Arab forces feeling the loss of their patron and Israel feeling less threatened.

These changes had perceptual repercussions as well. The decades-long Soviet-Arab alliance created in the Israeli mind, both on the strategic level and in the popular consciousness, an "enemy picture" that included not only Israel's immediate adversaries, but also the whole Soviet bloc. The Soviet persecution of Jewish activists within the USSR just added another dimension to the Israelis' subjective feeling of having to confront a very dangerous ally of their enemies, a real "Evil Empire." For a country besieged for almost half a century by its immediate neighbors, the perception that it was being threatened by the second largest superpower intensified still further the feeling of being cornered. It was no accident that when then-Prime Minister Menachem Begin wanted to clinch the argument against establishing a Palestinian state on the West Bank and Gaza, he raised the specter of Soviet troop deployment there—"12 kilometers from Tel Aviv." Hyperbolic as such a statement may have been, the necessity for Israel to contend not only with Arab enmity but also with Soviet support of it clearly added to the Israeli feeling of insecurity and significantly limited Israel's room to maneuver.

The breakup of the Soviet Union and the beginning of outspokenly friendly relations between Israel and practically all former Warsaw Pact countries and the republics of the former Soviet Union have enhanced both the subjective feeling and the objective realities of Israel's security—and the chance of peace in the area as well. An Israel confronting Syria as such (or, as the Israeli saying goes, "*Syria netto*") rather than a Syria enjoying a Soviet umbrella, can take much greater risks and be far more flexible in the peace process, as well as in the Palestinian aspect of the negotiations.

The lifting of the Soviet shadow from the region has also affected the nature of American support for Israel. During the Cold War it was obvious to the

United States that Israel was a strategic asset whose very existence and whose military power blocked Soviet encroachments in the area. Were it not for Israel, the Soviet Union would find it much easier to subvert the pro-Western regimes in countries such as Jordan and Saudi Arabia. With the end of the Cold War, and with the removal of the Soviet Union itself, Israel's stature as a strategic ally of the United States was naturally diminished. The extent of the change became evident during the Gulf War (the first post-Cold War conflict in the region), during the fall 1991 controversy between the Bush and Shamir administrations over the \$10 billion in loan guarantees requested by Israel, and in the much more "even-handed" U.S. policy that made it possible to convene the Madrid peace conference on October 30, 1991. None of these developments signified a decoupling of the special U.S.-Israel relationship, and the recent electoral changes in both Israel and the United States may even intensify some aspects of it. But the strategic aspect of the relationship will have to be redefined. Though the unique threat to Israel posed by the Soviet support for radical Arab nationalism has greatly diminished, other threats (Islamic fundamentalism, Iran) common to Israel and some of the region's Arab countries may grow and thus may help give rise to a realignment of some of the players—though in typical Middle Eastern fashion some of this may not be done explicitly. But the whole map of potential alliances and possibilities has clearly changed.

Israel's Roots in Central and Eastern Europe

On the cultural level, the end of the Cold War has reopened Eastern Europe to the Israelis and posed some fundamental questions connected with Israel's own identity. Israel is a Middle Eastern country, and its future and security will depend on the way it is able to work out its relations with its regional neighbors. But the Jewish people, as it developed in its majority in the past 500 years, and the Zionist movement, as a political movement that gave birth to Israel as a nation, are deeply interwoven with the histories and cultures of Eastern and Central Europe.

Before 1882, when the great mass of Jewish immigration from the Russian Empire to the West and to Palestine started, more than 80 percent of the world's Jews lived in two countries: the czarist Russian Empire and the Hapsburg Austro-Hungarian Empire. And the great national and social upheavals in these areas gave rise to the cultural and intellectual renaissance, the Jewish *Haskala* (Enlightenment), that later led to Zionism.

It is only within this background, where Jews found themselves in the middle of competing national movements and social transformations, that one can understand the emergence of Zionism and the cultural revival that preceded it. Zionism as a national movement has been greatly inspired by Polish, Czech, and Hungarian nationalism, just as the revival of Hebrew literature in Eastern Europe has been greatly influenced by Polish romanticism and the Russian literary tradition (even contemporary Israeli writers of the younger generation, born in Israel, like Amos Oz

and A. B. Yehoshua, can be understood only in terms of Chekhov and Turgenev). Similarly, the revival of Hebrew as a literary and spoken language, and not just a mere sacral tongue, owes much to the centrality of language in the revival and preservation of identity in Polish, German, Czech, and Hungarian nationalism. The complex and sometimes infuriating blend of ethnicity and religion in Israel, so alien to the Anglo-Saxon world, traces many of its perplexities to the idiosyncracies of Jewish history, but similar links can be found in all Eastern European national movements, from Poland, Romania, Bulgaria, Ukraine, and Russia itself, to the current overlap of ethnicity and religion in the former Yugoslavia. Even the Israeli system of proportional representation has its origins in post-1918 parliamentary traditions of Eastern Europe, Poland in particular. Just to underline this, the Israeli national anthem, *Hatikva*, was consciously fashioned after the Polish anthem: the Polish starts with the line "Poland is not yet lost," while *Hatikva* begins, "Our hope is not yet lost." Anyone familiar with Israeli music will immediately recognize its Eastern European origins, just as every connoisseur of Israeli politics knows that to understand the history of Israeli left-wing politics one has to delve into the debates between Narodniks, Bolsheviks, and Mensheviks, while to understand the Israeli right-wing one has to be conversant with Jozef Pilsudski and other Eastern European integral nationalists.

From this tradition, not the only one in Israel's kaleidoscopic culture, but certainly the dominant one, Israel has been brutally severed twice in the past half-century: first by the Holocaust, then by the emergence of communist regimes in Eastern Europe, whose policies over time became more explicitly anti-Israeli, anti-Jewish, and occasionally antisemitic. While other Israeli Jewish communities (the Yemeni, the Moroccan, the Kurdish, the Iraqi—who together make up about half of Israel's Jewish community) were able to delve into their historical memories and traditions and forge their identity as Israeli Jews in the context of their historical experiences, a physical and psychological barrier developed between many of Israel's Eastern European immigrants and their origin.

Over four decades, for most Israelis, Poland, for example, became identified with Auschwitz and the Warsaw Ghetto uprising. That Jews have lived in Poland for almost a thousand years, have survived despite repeated persecutions, and have created a rich Jewish culture that to a large extent became the defining factor in modern Jewish identity, was mostly forgotten. That Odessa was the capital of Hebrew letters in the 19th century was remembered only by archivists. That Prague was the largest Jewish center in Europe in the Renaissance and boasted of Jewish scholarship almost unparalleled in history was subsumed under memories of the Holocaust and the anti-Jewish Slansky trials under communism. That most of the Hebrew literature taught in Israeli schools was written in Eastern Europe and sometimes evoked its landscape was usually overlooked, and in any case made much of this literature unintelligible to generations of younger Israelis. This ambivalent reality of

Eastern Europe in Israeli culture can be seen even in the poetry of the most radically right-wing and ethnocentric Israeli poet, Uri Zvi Grinberg, born in Galicia, who wrote in the 1920s:

We had to hate even what we loved.

We loved the forest, the river, the well and the mill.

*We loved the foliage, the fish, the pail, the bread,
and secretly,*

Very secretly, we loved even the sound of their bells

And the gentile urchins with their bleached hair.

And because Israelis could not travel to Eastern Europe, this whole world was made into an abstraction, distant and threatening like the dark side of the moon. What was left was sometimes a kitsch commercial exploitation of this, as in *Fiddler on the Roof*. The reality, with its powerful ambivalence, was not there.

A Return to the Roots

A very central part of Israel's complex culture is Middle Eastern. But the "European" part is, after all, not Scandinavian or Italian; it is Eastern European. And it is to this real Europe, with its mixed heritage of Polish romanticism, Russian positivism, social visions, and national cultures (and hatreds), that Israel is now returning. This shows itself in the dozens of Eastern European cultural exchanges with Israel. Polish and Hungarian writers are coming to Israel, as Israelis are going to Eastern Europe, finding, sometimes to their surprise, that even if they do not speak the language, they understand the music. Younger Israelis are traveling to Eastern Europe to find the villages and *shtetls* of their parents or grandparents—not out of nostalgia, but out of keen interest to understand better their own origins, their own family history, their own identity. The 400,000 new immigrants who have arrived in the past three years from the countries of the former Soviet Union add a further dimension to this link between Israel and Eastern Europe.

While the rediscovery of Israel's Eastern European past may not have immediate political consequences, the impact nevertheless transcends culture. Israelis begin to understand that conversations about Europe are not necessarily about Brussels, that European literary traditions and vogues do not necessarily come from Paris and London exclusively. Students of Jewish history can now consult archives in Moscow, St. Petersburg, and Warsaw, rather than having to rely on snippets to be found at Oxford or the Sorbonne. Israeli exporters equally find it easier to export to post-communist societies than to Western Europe and North America.

Israel is, in a profound way, becoming more in touch with its own history, less alienated and estranged from some of the formative elements of its own identity. The result is an added feeling of self-assurance. And if it is true that the end of the Cold War, by removing the Soviet threat lurking over the horizon, has greatly reassured Israelis politically and strategically, the unique Israeli "Return to (Eastern) Europe" will equally reassure other layers of their consciousness. Therein lies a great contribution to peace and stability in the area. ■

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AFRICA

AND THE

New World Dis-Order

Rethinking Colonial Borders

FRANCIS
M. DENG

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As the drama of the fall of the Berlin Wall and the breakup of the Soviet Union begins to recede into memory, overtaken by the Persian Gulf War, the wars in Yugoslavia, and the landing of U.S. troops in Somalia, the notion of sovereignty within national borders becomes an ever more pressing issue.

The world seems to be of two minds—and moving in contradictory directions—regarding national borders. On the one hand are moves, as in the European Community, toward overriding national borders in favor of enlarged unity. On the other hand are moves toward fragmentation, whereby new and sometimes deadly borders are erected *within* old states, as in the former Soviet Union and in the former Yugoslavia. These two contradictory models would seem to suggest that in this new world order, those who have been oppressed by the concentrated power of the centralized system of the nation state are asserting the need for self-determination, while those already free are choosing to modify sovereignty and move toward larger cooperative frameworks.

Nowhere is the tension between the opposing trends of unity and autonomy or independence as pressing as it is in Africa, where the colonial borders have been perceived as both artificial and sacrosanct. The signal from the developments at the international level is that old assumptions about borders and nationhood are now under severe scrutiny, to say the least. Ethiopia, which appears set to give its ethnic groups the right of self-determination, may well prove to be a test case for the future. The time seems ripe for revisiting the colonial borders drawn on the map by European powers nearly one hundred years ago.

The Constraints of the Old Order

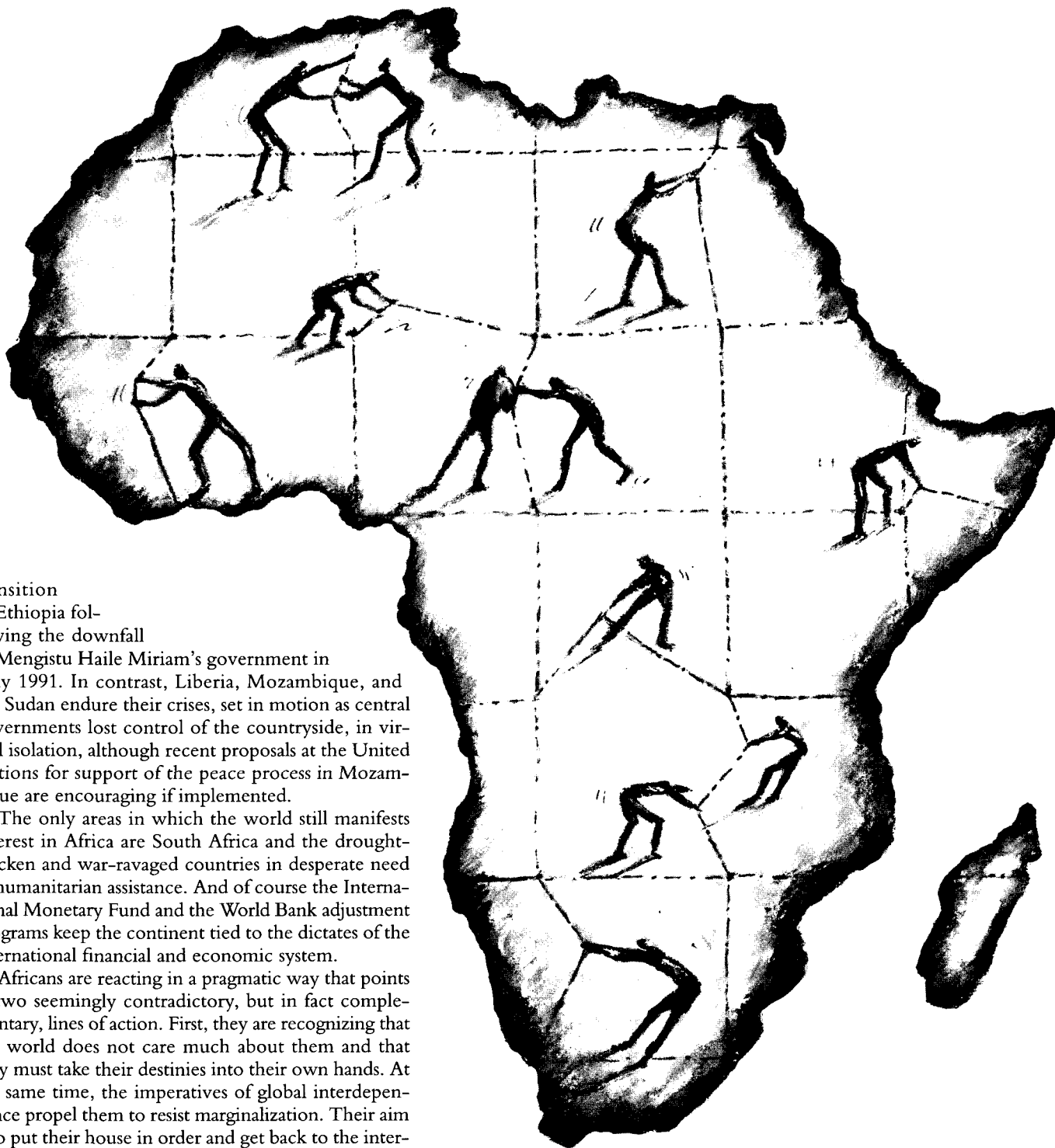
During the Cold War, the debate on conflicts around the world, and especially in Africa, centered on whether they were internally rooted or provoked by the ideological rivalry between the superpowers. The

question was critical to how those conflicts should be addressed and managed. If the causes were internal, then remedies had to be sought internally. If they were related to the superpowers' rivalry, then not only had the solutions to be sought through them, but their support for their allies was a given. The debate generally dichotomized positions between those who welcomed and even sought external intervention as necessary and those who resisted it as an undesirable complication and aggravation of internal or regional conflicts.

Now that the Cold War has ended, from the point of view of strategic and ideological considerations, the major powers have largely withdrawn from third world concerns—bearing out early fears of Africans that the end of the bipolar confrontation would result in what is now popularly conceived in Africa as marginalization. External strategic and ideological considerations thus having been removed, African problems now exist in regional and national, but not international, contexts. Causes and effects of conflicts are increasingly recognized as primarily internal, a development with both positive and negative implications.

In the past Africa was tied into global structures and processes, first by colonial intervention and then by Cold War ideological linkages into a chain of interdependent dependency. Absent those ties, self-reliance, both in the resolution or management of conflicts and in development, is increasingly imperative. However, having been dislodged, by their colonial past, from the indigenous values and institutions that permit building from within, Africans are left hanging between the local and the global systems.

With the striking exception of recent developments in Somalia, devastating conflicts in Africa no longer seem to draw world attention. The decolonization of Namibia, the dismantling of apartheid in South Africa, and the peace process in Angola all took place under the watchful eyes of the world at large. The United States played a catalytic role in the



transition in Ethiopia following the downfall of Mengistu Haile Miriam's government in May 1991. In contrast, Liberia, Mozambique, and the Sudan endure their crises, set in motion as central governments lost control of the countryside, in virtual isolation, although recent proposals at the United Nations for support of the peace process in Mozambique are encouraging if implemented.

The only areas in which the world still manifests interest in Africa are South Africa and the drought-stricken and war-ravaged countries in desperate need of humanitarian assistance. And of course the International Monetary Fund and the World Bank adjustment programs keep the continent tied to the dictates of the international financial and economic system.

Africans are reacting in a pragmatic way that points at two seemingly contradictory, but in fact complementary, lines of action. First, they are recognizing that the world does not care much about them and that they must take their destinies into their own hands. At the same time, the imperatives of global interdependence propel them to resist marginalization. Their aim is to put their house in order and get back to the international scene with a renewed sense of legitimacy.

The moves are not sequential but concurrent. Recent years have witnessed a wave of earnest self-criticism in Africa among intellectuals and even incumbent political leaders. Promoting democracy and human rights has become a high priority in the African debate. The Organization of African Unity Charter on Human and Peoples' Rights, the so-called Banjul Charter, was a symbolic step in this process. The Conference on Security, Stability, Development, and Cooperation in Africa, Africa's so-called Helsinki process, was initiated by General Olusegun Obasanjo's African Leadership Forum, endorsed by the Kampalla Confer-

ence in 1991, and is now under consideration by the OAU. Also envisaged is an African Council of Elders, mostly former heads of state and government who have retired respectably and can continue to offer leadership, primarily in mediating between parties to domestic and regional conflicts.

The OAU Secretary-General has also revived the dormant Commission on Mediation, Arbitration, and Conciliation and has established a conflict resolution unit in the Secretariat. Current OAU involvement in mediating civil conflict in Rwanda suggests

that the organization may find a more activist role.

If these moves can succeed, Africa will be in a better position to resist marginalization at the international level.

The Challenges of the New Order

African problems, whether in conflict management or development, must be approached from the perspective of their local, regional, and national contexts. Politically, the starting point, as in most matters pertaining to Africa, has to be the colonial nation state, which brought together diverse groups that it paradoxically kept separate and unintegrated. Regional ethnic groups were broken up and affiliated with others within the artificial borders of the new states, with colonial masters imposing a superstructure of law and order to maintain relative peace and tranquility.

The independence movement was a collective struggle for self-determination that reinforced the notion of unity within the artificial framework of the newly established nation state. Initially, independence came as a collective gain that did not disaggregate who was to get what from the legacy of centralized power and wealth. But because colonial institutions had divested the local communities and ethnic groups of much of their indigenous autonomy and sustainable livelihood and replaced them with a degree of centralized authority and dependency on the welfare state system, once control of these institutions passed on to the nationals at independence, the struggle for control became unavoidable. The outcome was often conflict—over power, wealth, and opportunities for development—that led to gross violations of human rights, denial of civil liberties, disruption of economic and social life, and consequent frustration of development.

As the Cold War raged, however, these conflicts were seen not as domestic struggles for power and resources, but as extensions of the superpower ideological confrontation. Rather than help resolve them peacefully, the superpowers often worsened them by providing military and economic aid to their allies.

Although the end of the Cold War has removed this aggravating external factor, it has also removed the moderating role of the superpowers, both as third parties and as mutually neutralizing allies. As Liberia, Somalia, and Sudan illustrate, the results have been unmitigated brutalities and devastations.

It can credibly be argued that the gist of these internal conflicts is that the ethnic pieces put together by colonial glue and reinforced by the old world order are now pulling apart and reasserting their autonomy.

Old identities, undermined and rendered dormant by the structures and values of the nation-state system, are reemerging and redefining the standards of participation, distribution, and legitimacy. In fact, it may be even more accurate to say that the process has been going on in a variety of ways and within the context of the constraints imposed by the nation-state system.

From the dawn of African independence, such slogans as Senghor's Negritude, Nkrumah's Conscientism, Kenyatta's Uhuru, Nyerere's Ujamaa, Mobutu's Authenticité, and Kaunda's Humanism have symbol-

ized African leaders' search for cultural legitimation of their political and economic objectives and strategies. Often the slogans were rationalizations for preconceived ideas and practices adopted from foreign prototypes and dressed up in local garbs, but they nonetheless expressed a genuine yearning for building on the culture of the people.

With the end of the Cold War, this yearning is gathering strength. Endowed with a deeper sense of the real world that mere slogans can no longer manage, Africans are now called on to find workable solutions to real problems—and in the framework of the new world order.

It is in this context that the revivalist Islamic trend in North Africa should be understood. In the Sudan, for example, the movement sprang up in reaction both to colonialism, which promoted Christianity and Western concepts of secular nationhood, and to the collaboration of traditional Muslim leaders with foreign powers, which reinforced conservatism in a situation that called for radical transformation. A twin movement in this direction, indeed the first to be born, was communism. Both were first and foremost reactions to domestic conditions, and both used ideological links to their international dimensions only as tools of management in an interconnected world.

In the Sudan, with the demise of communism, first locally after the abortive coup of 1971, which was used to justify a debilitating blow to the Communist party, and then internationally with the collapse of the Soviet Union and Eastern Europe, Muslim fundamentalists remained the only credible alternative to outmoded traditional political forces. The Muslim Brothers, who politically transformed themselves into the Islamic Charter Front and the National Islamic Front, infiltrated the army and won the support of the officers who took over on June 30, 1989, in the name of the Revolution for National Salvation, with Islamic revivalism as their agenda.

Islam in the Sudan has been closely associated with Arabism as a composite racial, cultural, and religious identity. Seen in the context of pluralism, however, the challenge that faces the Muslim revivalists is how to reconcile their religious legitimacy and basis of power with diversity and conflicting value systems within the nation state and the still interdependent world.

Western values and institutions, including the separation of religion and the state, that have thus far dominated the nation-state system have been widely adopted and internalized even by much of the Muslim community. In the South of the Sudan, national identity has evolved along indigenous African, Christian Western, and secular lines that contrast with the Arab-Islamic model of the North. Indeed, the two appear to thrive on their mutual antagonism and struggle for survival.

These complexities, however, do not invalidate the quest for cultural legitimation and the need to undertake nationbuilding and development from within the cultural context. The search for workable formulas must consider the conflicting demands for autonomy and equitable unity being made by various groups within the nation-state system. The operative princi-

ples in this respect must be autonomy, equity, and justice. But the observance of these principles requires a third party as mediator, moderator, peacemaker, and lawgiver. While regional organizations have a role to play, the most obvious institution called on to play a pivotal role is the United Nations.

It must be admitted that once the colonial powers accomplished the brutal task of conquest and pacification, they established a system of public order and justice that brought peace to interethnic relations that had been afflicted by chronic violence throughout recorded history. While colonial intervention understandably provoked nationalistic reactions that ultimately culminated in the independence movement, the postulated role for the United Nations—establishing peace, justice, stability, and prosperity—has a more compelling and disarming justification. A political, economic, social, and cultural system that autonomously uses local resources and resourcefulness within the framework of regional and global interaction and interdependency can be designed to reconcile the lofty ideals of unity with the imperatives of segmentation and fragmentation. As units of participation and social orientation, the family, the clan, and the tribe can indeed be complementary rather than antagonistic to the nation and the global order.

The United Nations in the New Order

Before the Persian Gulf War, the West saw the United Nations as a third world club and a forum for bashing the West, in particular the United States. The Gulf War and its aftermath turned the organization, in the perception of the third world, into a Western, specifically a U.S., tool for global control.

The United States, or more appropriately George Bush, did not shy away from the role of leadership that the new view of the UN places on the West, especially the United States. Despite resentment by many member states of the inequalities of a system that has hitherto paid lip service to the principle of equality among members, the real test is the extent to which the United States lives up to the ideals of political, economic, and moral leadership, whether it operates individually or through international institutions.

Although states are usually assumed to be motivated by national interests, the role of a world leader certainly carries with it burdens that should transcend those interests. There is obviously considerable controversy in the United States about what George Bush meant by a new world order, what responsibilities he envisaged for the U.S. leadership in that order, and what financial baggage that leadership entails. Generally speaking, not much has been read into Bush's rhetoric, especially its financial implications. When that controversy is resolved, the United States will have to be clearer on what the new order means, whether and how the United States will assume the leadership role, what the guiding principles of that leadership will be, and how it will translate itself in the specific regions of the world where international action is needed to address urgent issues. Somalia already has imposed itself on the international agenda, and the former Yugoslavia is competing for attention, but

there are many more candidates, and the ultimate objective should be a comprehensively peaceful, just, and orderly world.

A New Berlin Conference

If progress is assumed to be an integral part of human development, then the emerging new world order must signify an improvement on the way things have been. The central themes of this improvement must be realizing seemingly contradictory trends, the quest for autonomy and the need for broadening circles of cooperation regionally and internationally. Leadership at the international level must pursue the ideals of freedom, democracy, justice, and prosperity for all nations and peoples worldwide. World leaders cannot discriminate between their own favored nationals and the marginalized nationals of foreign nations, at least not to a degree of dispossession. Liberating Kuwait must be defended only on universal principles, not in terms of limited national strategic objectives, if the role of the United States as the driving force behind UN action is to be viewed as global leadership. The same principle is more glaring in the case of protection for the Kurds in Iraq. This in turn imposes an obligation on the United States and the United Nations to exercise the same responsibility in comparable situations of need for international action.

As the Somali case indicates, tragic situations of that magnitude cannot be left to local actors when the extent of human suffering and destruction of life and property far exceeds what should be tolerable even by minimum standards of human dignity and global responsibility. If the international community does not extend the logic of action in Somalia to other areas of massive suffering, what we are witnessing may prove to be a new world disorder. Nearly a century ago, in 1884–85, the major European powers met at the Berlin conference and carved the African continent into pieces of real estate over which they extended colonial dominion. Perhaps the time has come for another Berlin conference, at least a metaphorical one, with a different venue, participants, and guiding principles.

Rethinking the borders does not necessarily imply dismantling existing ones. What is required is a comprehensive strategy for addressing realistically the problems that threaten those borders from within. Only if it proves impossible to find workable solutions within unity can the revision of borders be justified. But when that conclusion is reached, borders should no longer be regarded as untouchable. If we are to rethink the colonial borders to give greater meaning to self-determination and the principles of democracy and human dignity, policy analysts must begin to clear the way in what is now a tangled thicket. ■

World leaders cannot discriminate between their own favored nationals and the marginalized nationals of foreign nations.

This article is the second of a two-part series examining the global drug challenge in the post-Cold War era.

WORLDWIDE DRUG SCOURGE



THE RESPONSE

Lieutenant Stephen Flynn is a Coast Guard officer who is serving as a guest scholar in the Brookings Foreign Policy Studies program. This article grows out of a year-long project he undertook at the Center for Strategic and International Studies and is adapted from The Transnational Drug Challenge and the New World Order (CSIS, 1993). The author gratefully acknowledges the help of Paul Stares, a Brookings senior fellow with whom he is now working on a drug policy research project.

The 1992 presidential campaign came and went with hardly a word about one of the most vexing policy challenges of our time: what to do about illicit drugs. The lack of a public dialogue by the candidates reflects what seems to be a growing resignation by politicians and the American people that not much can be done. If Americans are frustrated, it is with good reason. Despite billions of dollars in tax revenues, stiff criminal penalties, the invasion of Panama, and what seems like daily reports of "record" seizures, 26 million Americans used illicit drugs last year, and heroin, cocaine, and marijuana remain cheap and readily available in practically every city neighborhood in the United States.

The sense of hopelessness and resignation is understandable, but it comes at a bad time. What has been labeled as the "American disease" is now a global epidemic. Production of heroin, cocaine, cannabis, and synthetics is already at an all-time high, and new drug producers are emerging in Central and South America, Africa, Asia, and Central Europe. The tumultuous political and economic changes connected with the passing of the Cold War era are proving to be a boon for organized crime. Along with the Colombian cartels, Chinese, Georgian, Italian, Lebanese, Nigerian, Pakistani, Polish, Turkish, Vietnamese, and other trafficking organizations are aggressively developing new drug markets. The seeds for widespread drug consumption exist practically everywhere, and the signs are that drug abuse is spreading swiftly to the third world and many former communist states.

As governments around the globe begin to wrestle with the drug issue, it is tempting for the United States to leave them to their own devices. After all, U.S. resources are finite, and law enforcement and public health officials have more than enough challenges here at home. For years many foreign leaders have rebuffed U.S. calls for a concerted international effort to stem the supply of drugs. U.S. diplomats have been told bluntly and often that the illicit trade in narcotics was a problem of their own making, spawned by pleasure-seeking Americans unable to exercise self-restraint. From the perspective of many foreign governments, the solution to the international drug problem rested not with bilateral and multilateral efforts to eliminate supplies, but with a unilateral effort to curb American demand.

A War That Shouldn't Just Be Fought at Home

Why not limit the war on drugs to the domestic front? The short answer is that the potential political, social, and economic costs of an isolationist response are enormous and place at risk a host of U.S. objectives for the post-Cold War world.

First, the criminal organizations and insurgency groups enriched by the drug trade are politically destabilizing. When the drug trade becomes entrenched within a state, democratic institutions and processes are threatened. In Colombia, drug lords have used graft and violence to undermine judicial authority, disrupt elections, and intimidate politicians and the press. In Peru, the government's battle with narco-terrorism has resulted in an appalling human rights record and, in April 1992, in the suspension of constitutional government. As drug networks grow in the former Soviet Union and Eastern Europe and leave a trail of terror and corruption in their wake, they pose a similar threat to the democratization movement in Eurasia. And the spread of crime and drugs provides a rallying point for the reactionary forces who associate these vices with the demise of the old socialist order.

Second, widespread drug abuse promises to contribute to the myriad social problems that already jeopardize the ability of many third world countries to develop into strong U.S. trading partners and stable allies. As drug experimenters are drawn into dependency, many will drop out of school and the work force and resort to crime to finance their drug habits. For women of child-bearing age, addiction promises a surge in children born with serious physical and neurological problems. Particularly worrisome for already overburdened public health resources is the inevitable spread, through needle use, of infectious diseases such as AIDS and hepatitis.

Third, the smuggling success of drug traffickers may erode political support for a more open global economy. The case of the U.S.-Mexican border is suggestive. The almost 300 million crossings along the 1,951-mile border last year made it impossible for U.S. border patrol and customs agents to keep drug traffickers and illegal immigrants from entering the country. Protests have arisen from some quarters that adopting the North American Free Trade Agreement will only make matters worse. There have even been calls to seal the border altogether. In the end, the close economic ties between Mexico and the United States and the long-standing U.S. commitment to economic liberalization will enable the free traders to carry the day. But it is less certain whether East Europeans and the peoples of the former Soviet Union would also make the same decision if faced suddenly with a surge of illicit drugs across their borders. There the principle of free trade has very shallow roots.

Finally, the money laundering connected with the drug trade threatens to slow the integration of many national financial systems into the global economy. Generally poorly regulated, the banks in most third world countries and states like Poland, Hungary, and Estonia have few of the human skills and little of the technology required in the modern financial services industry. Most lack the means to distinguish legitimate from illegitimate deposits, making these rudimentary banking systems easy targets for money launderers. *Once this criminal activity becomes entrenched, the opportunity for pursuing essential bank reforms evaporates. Frequent scandals and the undermining of international confidence are the inevitable results.*



In short, the surging global drug epidemic presents a threat to the post-Cold War world, especially the development of democracy and the global free market economy, that the United States would overlook at its peril. As events in Iraq, the former Yugoslavia, and Somalia have amply demonstrated, it is too early to declare that the collapse of the communist world represents the end of history.

Hard Realities

But if U.S. policymakers must respond to the global drug scourge, what form should their response take? We must begin by accepting two hard facts of life. First, we will never *end* the trade in illicit drugs. The best we can hope for is to contain it within tolerable limits. Second, our penchant for pursuing unilateral and bilateral drug control initiatives must be reassessed in light of the need to forge an international anti-drug coalition and to craft multilateral responses.

Why can't we win the war on drugs? When the drug problem is placed in its global context, the reasons seem almost self-evident. We cannot hope to halt the production of drugs because the base crops—coca, poppy, and cannabis plants—can be grown virtually anywhere by almost anyone. The modern transportation revolution enables these drug crops to reach international markets no matter how remote their origin, while impoverished and politically unstable governments seldom have the capabilities or the will to do much in response. Even if by some miracle we could eliminate the base crops, the modern laboratory promises to produce an array of synthetic drugs as substitutes.

Another barrier to victory is the post-Cold War international economy. A global market economy relies primarily on the free exchange of goods, services, labor, and capital across sovereign borders. As the global economy grows, so does the challenge of tracking human and commercial activity across those borders. No customs effort in the world could conduct detailed inspections of the 430 million people, 120 million automobiles, 8 million containers, 720,000 jets and small planes, and 290,000 ships and small boats that cross U.S. borders in a single year. But somewhere amidst that traffic is all the cocaine to satisfy the American coke habit for a year—enough to fill only 13 tractor trailer trucks.

Human nature itself militates against winning the drug war. Reasons for using drugs are universal and timeless. Individual factors include youth, personality, and temperament. Environmental factors include family and peer relationships, schooling, and cultural and societal values. There will always be impulsive, sensation-seeking personalities whose family and social conditions foster drug experimentation. Some experimenters will succumb to addiction. Meanwhile, the market for psychoactive drugs will thrive.

Even though the drug war is not “winnable,” we cannot afford to throw in the towel. The stakes are too high. We must simply set more realistic expectations about what we can achieve. We know, for example, that achieving world peace and eliminating world hunger and disease are at best distant dreams.

But we are committed to pursuing those dreams, even though the setbacks are many and the breakthroughs only occasional.

International Cooperation Is a Must

A purely national response, no matter how aggressive, has false promise. As with other global problems—weapons proliferation, terrorism, disease control, migration, and ozone depletion—states can do little on their own to stand up against the rising tide of drug production, trafficking, and consumption. What is now the primary goal of U.S. international drug control policy—to reduce the supply of illicit narcotics flowing into the United States—must be made secondary to the goal of reducing the amount of illicit narcotics cultivated, marketed, and consumed worldwide. The only way to reach this goal is to generate and coordinate an international response.

Beginning with production, only a multilateral response can produce enough carrots and sticks to encourage a state to take action against cultivators. No crop eradication strategy will work unless it is part of a larger alternative development program. No government of a producer state will support such a program aggressively unless it can thereby derive greater benefits (or absorb fewer costs) than it can by simply giving its tacit approval to drug cultivation. And no alternative development program will meet this criterion unless it can both tap into the collective resources of the international community and guarantee global opprobrium and isolation for noncompliance.

Combating trafficking requires a similar approach because only a coordinated international effort can close the avenues in an increasingly open and unregulated international economy. To move illicit merchandise, whether precursor chemicals, drugs, or money, the trafficker need only find the weakest points in the marketplace. When the United States tightens controls on chemicals, he can buy them in Brazil and Libya. If inspections at airports and maritime terminals in Western Europe are intensified, he can fly first to Budapest or Prague and then cross the land border into Germany or Austria. If the Group of Seven (G-7) countries orders its banks to monitor depositors more closely, he can place his money in Dubai or Warsaw, layer it to disguise its origin, and then move his assets into a first-tier bank. An ample menu of alternatives like these will always be available as long as the international community encourages states to enter the global economy while permitting a multiplicity of regulatory rules or vastly differing levels of enforcement.

As a host of multilateral organizations such as the European Community, the G-7, the World Bank, and the International Monetary Fund work to promote a new global economic order, conditions should be attached to aid and trade concessions to former communist and third world countries. Development assistance should be tied to a recipient government's commitment to curb any activity that advances transnational threats such as arms proliferation, terrorism, and the drug trade. Subsequent aid should be tied to results. Since many of these countries lack the resources and

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technical means to put enforcement regimes in place, they should receive financial and technical help from the United Nations International Drug Control Program (UNDCP), the IMF, the International Maritime Organization (IMO), the International Criminal Police Organization (INTERPOL), and regional organizations such as the Inter-American Drug Abuse Control Commission (CICAD).

Drug consumption, too, must be dealt with multilaterally. In the long run, reducing global demand is the only effective way to suppress the transnational drug trade and the traffickers who profit from it. As long as drug commerce and abuse flourish somewhere, drug products and fashions will be marketed and developed practically anywhere. The speed with which crack cocaine appeared and spread makes the case. In the spring of 1985 U.S. human services officials did not even have a common name for the new and particularly potent derivative of cocaine that field agents were beginning to report. By the fall, crack was front-page news in New York, Los Angeles, and Miami. Within a year it was on the streets of practically every big city in the United States. Now crack has made its way into cities across Europe and North and South America, and even, in more limited quantities, into Africa and the Pacific.

As the world's largest drug market, the United States has the greatest incentive—and the greatest responsibility—to lead the international community in developing a collective response to the human tragedy of drug abuse. States need to be in constant communication about what new drugs are emerging, how they are used, and what approaches seem to work in response. The sheer scope of the problem requires a collective effort. Further, as the U.S. experience suggests, successful drug education, prevention, and rehabilitation ultimately must be undertaken at the local level and adapted to local circumstances. To this end, local leaders from the public and private sectors across all cultures and societies must be enlisted in a collective effort from the outset.

Any mobilization effort to redress global demand should include organizations like the UNDCP, the World Health Organization, the UN's Children Fund (UNICEF), the International Labor Organization, private voluntary organizations (PVOs) such as the International Drug Free Workplace Partnership, and the InterAmerican Foundation that funds PVOs throughout Latin America. Multinational research on the sociocultural aspects of drug consumption should be supported. Informational and exchange programs for drug prevention and treatment professionals should be liberally funded.

Financing an International Strategy

The value of promoting and investing in multilateral drug control initiatives has not been lost on many drug control veterans in the U.S. government. Most international programs—such as those that target drug refinement chemicals and money laundering—can trace their origin to visionary Americans who resigned themselves to combating bureaucratic and diplomatic resistance, both at home and abroad,

to enlisting overseas allies in stemming the drug trade.

Although multilateral drug control programs generally have enjoyed strong rhetorical support from U.S. policymakers, the budgetary backing has been much more restrained. Only one-tenth of 1 percent of last year's \$11.9 billion U.S. national drug control budget went to multilateral drug programs administered by agencies such as INTERPOL, UNDCP, and CICAD. Such a meager U.S. commitment sends a demoralizing message to these organizations. Taking \$250 million (2 percent of the overall 1993 drug control budget) from the costly and largely ineffective U.S. overseas interdiction effort and contributing it to these multilateral programs would allow them to play a far more meaningful role in any international drug control strategy *and* give them an incentive, which they have so far lacked, to be responsive to U.S. leadership.

Learning from Failure

The United States has been very committed in its battle with illicit narcotics for almost a decade now. Despite tight national budgets, U.S. government officials have not been shy in responding to America's drug epidemic—spending more than \$39 billion in federal revenues and billions more of state and local taxes in just the past four years. The perceived need to respond aggressively to the threat of illicit drugs has enjoyed widespread support among the American people and bipartisan support by their elected representatives. Intelligent and talented public officials have stepped up to the challenge, developing an ambitious and comprehensive national policy response. Thousands of dedicated and courageous field agents have put their lives on the line to carry out that policy. In short, America's drug control efforts have enjoyed all the ingredients typically connected with highly successful public policy. Yet the United States has failed to control the spread of illicit drugs.

The drug problem requires Americans to face one of the most vexing but incontrovertible truths of the post-Cold War era: a state can neither insulate itself nor independently resolve a threat that extends beyond its national borders. Meeting such threats will require a strategy of cooperative engagement that includes a broadly based alliance of international, regional, and nongovernmental organizations. It requires reordering budgetary priorities to ensure that the multilateral programs with the best prospect for success are well funded. It also requires that bureaucratically and conceptually the drug issue be moved from the back room and into the front parlor of the U.S. national security, foreign policy, and economic policy communities. To the degree that the expanding drug trade can potentially undermine the advancement of democracy, the opening of the global economy, and the peaceful resolution of conflict in many troubled corners of the globe, it must be considered side-by-side with more traditional overseas concerns.

These are the lessons of the failed American experience with drug control. The sooner we learn them, the better prepared we will be to respond to the worldwide drug scourge. ■

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DREXEL

SOME LESSONS FOR THE FUTURE

In a brief five-year period Drexel Burnham Lambert rose from relative obscurity to become one of the most profitable and powerful investment banks on Wall Street. After pleading guilty to six felony counts in January 1989, the firm's business spiraled downward, culminating in a liquidity crisis and bankruptcy just one year later. No series of events in recent financial history has aroused more interest than the swift rise and fall of this firm.

For the media, Drexel became a symbol of the "excesses of the 80s." Numerous books and articles have told us a great deal about what happened during these years, but they rarely focus on the broader implications of the Drexel affair for the capital markets. The criminal proceedings against the firm and Michael Milken have dealt largely with technical violations of the securities laws, making it difficult for the public to understand what went wrong. And the Securities and Exchange Commission, except for the bare bones of the settlement decree with Drexel, has not disclosed facts permitting the public to grasp the significance of one of its most important securities cases.

With the emergence of a smaller Drexel from bankruptcy, the settlement agreement with the numerous securities claimants, and the end of major legal proceedings, there remains an uneasy feeling that we do not yet fully understand this major force on Wall Street in the 1980s. This article seeks to fill that gap by drawing some lessons from the Drexel phenomenon that place the meteoric rise and fall of Drexel in a broader perspective—one that offers some insights into both the strengths and weaknesses of U.S. capital markets.

Lessons for Wall Street

The first lesson for Wall Street relates to a matter of current concern—corporate governance. The Drexel case helped define the rules governing what corporations should do when they suspect or have reason to believe that their employees may be violating the law.

Drexel provides a textbook example of an organization in a highly regulated business destined to have compliance problems. Michael Milken's High-Yield Bond Department operated independently as a firm within a firm based on a one-page letter executed between Drexel and Milken in 1975. Despite enormous changes in the role and profitability of Milken's fief-

*Ralph S. Saul,
a member of the
Brookings Board
of Trustees, served
as a court-appointed
member of an
Oversight Committee
to monitor the
liquidation of Drexel
and later as the
Chairman of
its Board in
Reorganization.
He is the former
Chairman of CIGNA
Corporation.*

dom during the ensuing years, the letter continued to govern Milken's compensation and his independent role within Drexel—and it planted the seed leading to the firm's problems with the law and its ultimate destruction.

The High-Yield Department, located in Beverly Hills, California, remained isolated from corporate headquarters in New York and from the hurly burly of Wall Street. It kept its own books and records, controlled access to the capital markets through its underwriting decisions, and set its own compensation. For a time Milken did not even put Drexel's name on the door of the office building, which he owned. Moreover, the Department's legal and compliance watchdogs, who could have flagged problems to senior management in New York, reported to and were paid by Milken. Drexel had no governing structure to monitor, control, and supervise effectively the huge money-making machine Milken had created. Nor did Drexel have in place a mechanism to test or verify what Milken told senior management.

When the government investigation of Drexel began in earnest, the firm neither cooperated nor investigated, but instead stonewalled, treating the affair as a "war." Drexel's senior management steadfastly believed in Milken's innocence and what he told them, despite allegations of regulators, competitors, and the media that something was amiss in Beverly Hills. None of the firm's advisers had the independence or courage to counsel top management that war with the U.S. government could produce only disaster. No wonder Drexel faced implacable government foes determined to punish it.

A financial institution must rely on self-regulation. Government regulation is no substitute for boards and top managements that know what's going on and actively and vigorously oversee activities. Once wrongdoing is suspected or detected, both boards and managements have the responsibility to investigate, to stop any wrongful conduct, to work with the regulatory authorities if necessary, and to take steps to prevent a recurrence. Legal advisers must not only support the process of self-regulation, but, when the client drags its heels, remind its board or senior management of its obligations. If, early in the game, Drexel had taken appropriate remedial action, the firm might have avoided the drastic sanction of a criminal conviction.

Since Drexel's felony convictions, the Department of Justice has codified these standards of conduct for preventing and detecting crime in its "Sentencing Guidelines." In this new era of corporate responsibility, it is imperative that boards and top managements of all corporations, as well as Wall Street firms, understand and comply with these standards.

Free and Open Public Markets

The second lesson is one that every new generation coming to Wall Street has to relearn. Market professionals, with their privileged access to the securities markets, assume special obligations to customers, clients, and the markets. The securities markets are, in contemplation of law and in fact, *public* markets. They should be "fair and honest" and "free and open"—to use the words of the Exchange Act. Moreover, the activities of market professionals should be guided by "fair dealing." Over the years, law and regulation have imposed on market professionals a complex set of responsibilities to achieve these statutory objectives. Milken, for all his vision and intelligence, lost sight of these fundamentals.

Drexel's High-Yield Bond Department started with a novel financial idea—first in trading non-investment-grade bonds and then in distributing them to the public through underwritten offerings. Many worthy entrepreneurial companies that would not ordinarily have had access to the public markets raised capital through Drexel sponsorship. Public high-yield debt offerings provided an alternative source of competition to banks, insurance companies, and other suppliers of commercial credit. Throughout the 1980s Drexel dominated this new market. By 1989, 20 percent of all corporate bond offerings in the United States emanated from Drexel's High-Yield Department.

Two things went wrong. First, Milken sought to monopolize the vast market he had created by excluding potential competitors. Second, through his control over access, he extracted monopoly profits. He tried to create a private securities market with its own set of rules—an objective at odds both with the securities laws and with Drexel's stated purpose of "democratizing capital."

Control over the market for high-yield bonds gave Milken the power to set the terms both for access and for exit. Detailed market intelligence about buyers and potential sellers provided an information advantage, both in underwriting new issues and, in the secondary market, in trading older bonds. Sellers had to turn to Milken for liquidity, and buyers had few other sources of supply. As sole market maker, Drexel set markups or markdowns on purchases or sales without fear of competition. Finally, in the absence of alternative markets, institutional investors depended on Milken for pricing their high-yield bond portfolios. It is hard to exaggerate the importance of having control over the pricing mechanism for a market of more than \$200 billion in outstanding high-yield securities.

It is unfortunate that Drexel did not see that competition would have broadened the market and given others a stake in its success. Competition would have

offered issuers alternative underwriting sources and buyers and sellers competitive trading markets. It might have curbed overreaching in the Department's underwriting and trading practices. Finally, it would have exposed Milken and his colleagues to the practices and standards of the investment banking community and their legal advisers—and might have forced him to question and perhaps restrain some of his practices.

Why—in the fiercely competitive world of Wall Street, where a new financial product rarely has an edge for more than a few years at most—was no competitor able to challenge Milken? First, to break into the market, competitors had to underwrite deals with higher risks and without Milken's placing power—power that gave Drexel investment bankers the ability to assure issuers that Drexel was "highly confident" it could place a high-yield offering. Second, and most important, no other firm on Wall Street was prepared to commit so much of its capital to inventory high-yield bonds in secondary market trading. Finally, would-be competitors had to overcome Milken's hold on clients and institutional customers and the extraordinary compensation levels that bound his subordinates to him. In time, the Milken mystique became so pervasive that it scared away competitors even when Milken's monopoly hold on the high-yield market might have been broken.

Putting Clients and Customers First

There is a third lesson for Wall Street. The Drexel affair demonstrates that compensation arrangements rewarding people excessively for acting as principal, not as agents, can drive behavior in ways that may sacrifice the interests of clients and customers.

By controlling access to the high-yield market, Milken extracted large amounts of noncash compensation in the form of equity or warrants from issuers or LBO sponsors based on his representation that this compensation would go to buyers of high-yield bonds. Instead, these securities were placed in hundreds of investment partnerships controlled by Milken and now estimated to have assets well over \$1 billion. Although Drexel senior management did not at first know about or authorize the partnerships, when it learned about them, it negotiated with Milken to allow the firm and its investment bankers to participate in them—thus making them a driving force behind not only the high-yield bond operation, but also the entire firm. Drexel investment bankers found that the partnerships offered higher returns than fees for acting as investment bankers.

The noncash compensation placed in the partnerships was disclosed neither to investors in high-yield bond offering documents nor to LBO sponsors. This "warrant stripping," as it was called, increased costs for issuers and diluted their equity, decreased potential returns for bondholders, and fostered an environment in which investment bankers and traders tended to serve themselves more than their clients.

Investment bankers receive high compensation for acting as intermediaries in screening and selecting issuers and in structuring and pricing issues to create

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long-term values for issuers and investors. Major investment banks survive and prosper because they live up to meticulous standards as underwriting professionals and successfully balance the conflicting demands of issuers and investors. Clients judge an investment bank on this track record over many years. Whenever investment bankers lose sight of these fundamentals, they risk the loss of clients' trust and confidence.

The conflict issues arising from acting as both principal and agent have become more pointed as the business profiles of major investment banks have changed over the past 20 years. The securities industry now derives most of its revenues and profits from principal or dealer activities such as merchant banking, program trading, arbitrage, creating derivatives, and trading in currencies and commodities. Wall Street, once the home of firms that largely served customers as agents or brokers, now features firms that derive most of their profits from acting for their own account. This change has been driven primarily by customer needs, technology, and the globalization of financial markets—market forces that have made it more profitable to act as dealers.

Meanwhile, and not coincidentally, Wall Street compensation has soared. While acting as principal can carry great risks (which Wall Street has learned how to control or hedge), it can also generate enormous profits.

Do these proprietary activities and the high pay associated with them come at the expense of fiduciary obligations to clients and customers? Are the inherent advantages of market professionals in the securities markets being exploited at public expense? These have been recurring questions since enactment of the securities laws in the early 1930s, and events of the 1980s raise them again. Drexel demonstrates what can go wrong when proprietary activities run amok and professionals subordinate clients' and customers' interests to their own.

Lessons for Institutional Investors

The high-yield market of the 1980s depended on the active participation of institutional investors—mutual funds, insurance companies, savings and loans, pension funds, and other asset managers. These investors enhanced their short-term performance with premiums from takeovers and management buyouts. At the same

time, many bought the high-yield bonds that financed these corporate restructurings.

Much attention has focused on a few institutions who helped ensure the success of Milken's deals. Milken offered them guarantees against losses on their high-yield bond investments when he arranged for them to hold new issues temporarily to create the illusion of high demand or to escape regulatory or other scrutiny. In the most egregious cases, he made side payoffs, awarding interests in his investment partnerships to portfolio managers in return for investing institutional funds in his issues. Such reprehensible conduct by a few institutions, however, should not obscure the important lessons for all institutional investors stemming from the Drexel affair.

First, institutions acting as agents for millions of individuals must be held to the same high standards of conduct they expect from Wall Street investment banks and corporate issuers. Asset managers cannot engage in activities that conflict with, or appear to conflict with, their fiduciary responsibilities. The conduct of institutional investors will become an even more pointed issue now that the SEC has adopted new proxy rules that allow institutions to communicate among themselves about corporate performance. As institutions become more active in monitoring portfolio companies, the corporations whose securities they hold and the investors for whom they act as agents will be watching. Will institutional investors, particularly public pension funds, try to advance politically motivated governance proposals or proposals that impinge on management's responsibility to manage? Will they try to obtain information advantages to the detriment of the individual investor lacking the same clout?

By taking a more active role in corporate governance, public pension funds risk pushing proposals and driving corporate managements to take steps that may have nothing to do with improving corporate performance. Ironically, they may find themselves subject to the same criticism as Drexel for fostering corporate restructurings that serve no economic purpose. There is an even greater danger that overzealous “activism” in corporate governance matters will become an irrelevant sideshow with little long-lasting effect on American competitiveness.

The most important lesson of all for institutions is

WHAT MAY BE NEEDED ARE CHANGES IN THE WAY AMERICAN INSTITUTIONS AND CORPORATIONS MAKE THEIR INVESTMENT DECISIONS.

that until the owners for whom they act as agents change the standards by which investment performance is judged, there will always be the danger of another Milken. The market for corporate control and management buyouts of the 80s was driven by the overriding goal of near-term appreciation. For most institutions, that goal has not changed. Current performance standards reward asset managers for near-term growth of assets and discourage them from developing long-term relationships with corporate issuers. Short-term behavior is also encouraged by trustees, directors, and corporate managements who hire asset managers and then focus on their monthly and quarterly results. Asset managers simply have no incentive to exercise long-term ownership responsibilities that may result in forgoing immediate gains and in increasing costs—the costs of monitoring company and management performance and, more dramatically, losing a client or, in the case of mutual funds, a wave of redemptions.

It is difficult to see how longer-term approaches to investing can succeed without fundamental changes in the behavior of asset managers. That change may require the kind of systemic reform for allocating capital recommended by Michael Porter, of the Harvard Business School, whose aim is to create an environment in which corporate and asset managers make investment decisions to maximize the long-term value of their corporation or portfolio holdings. In the absence of such reforms, it is doubtful that asset managers will change practices deeply embedded in the current culture of asset management, in the thinking of owners for whom they act as agents, and in the mindset of the financial community.

Lessons for Regulators

The public has a right to ask: why did Milken's activities persist for so long in the face of common knowledge in the financial community that something was wrong in Beverly Hills? Why did no one warn Drexel senior management well before the firm pled guilty to six felony accounts? These questions are not easy to answer. What is clear is that the elaborate regulatory and enforcement safeguards set up over decades to prevent a Milken episode failed.

In retrospect, this matter probably did not have to go as far as a criminal conviction of Drexel. If the

regulatory or self-regulatory authorities had intervened earlier, Milken's more egregious practices could probably have been curtailed and Drexel might have survived. For example, how did Milken avoid public disclosure in high-yield bond offering documents of the hundreds of millions in equities or warrants that he took as underwriting compensation from LBO sponsors and placed in his investment partnerships? Early enforcement action against these and other practices might have forced the firm to supervise Milken's activities more intensively and might have averted tragedy for many individuals and the bankruptcy of a firm employing more than 10,800 people, most with no connection to the High-Yield Department.

With Drexel's criminal conviction and its settlement with the SEC, it may appear captious to talk about what might have been. Certainly, stonewalling by the firm and its legal advisers hindered the investigation, and Milken's mode of operation complicated getting at the facts. However, it is not too much to ask of the SEC and the self-regulatory agencies that they, in light of the passage of time and the cooling of passions stirred up by this case, examine why existing safeguards did not come into play sooner. From such an examination, these agencies might also learn some important lessons for the future.

After Drexel's criminal conviction and with the emergence of the savings and loan crisis, both Congress and regulators took actions that, in hindsight, did not serve the public well. In its 1989 S&L legislation Congress required thrifts to value their high-yield positions at market and to sell them within five years. Insurance regulators also joined the anti-junk-bond crusade. The two together aggravated losses for S&Ls (and the Resolution Trust Corporation, the agency entrusted with managing failed S&Ls) and insurers, who were forced to sell off their bonds in a rapidly declining market. Meanwhile, the demand for high-yield bonds by mutual funds evaporated as a drumbeat of bad publicity further soured the public on the bonds. In light of the subsequent recovery of the market, this relentless hazing served only to destroy values for taxpayers, creditors, and investors. Next time, legislators and regulators would be well advised to think more carefully about the market, as well as the political consequences of their actions.

Another important lesson for the future is that the bankruptcy of a major investment bank with global interrelationships and commitments involves huge risks for the entire financial system. Before the Drexel bankruptcy no one had any experience in unwinding or working out \$126 billion of positions in mortgage-backed securities; interest rate swaps; spot, forward, and future commitments in foreign exchange and commodities; and other financial instruments.

Despite enormous difficulties, the wind-down process incurred minimal losses in relation to the size and complexity of the positions. It set an example of what can be done when all parties—in this case, the SEC, the New York Stock Exchange, the Treasury, and the Federal Reserve—cooperate to minimize disruption to the financial markets. Gerald Corrigan, president of the New York Federal Reserve Bank, has described the Drexel liquidation this way: “Only by good fortune, good planning, and an enormous amount of very hard work—including hard work by personnel of Drexel itself—were we able to narrowly dodge another bullet which, press reports notwithstanding, had the clear *potential* to inflict damage on the system more generally.”

A final lesson for regulators involves their dealings with the news media when investigating and prosecuting important securities cases. In the Drexel case, leaks by regulators and prosecutors greatly complicated their task of developing public understanding of what went wrong.

Drexel attracted enormous media interest, and, indeed, the media educated the public on what happened at Drexel, bringing out more facts than either the regulators or the prosecutors. Significantly, there was no public investigation in the wake of the Drexel case to determine the possible need for additional legislation or regulation. We have depended on the media to perform that function.

To its great credit, the media suspected that something was amiss in Beverly Hills, and its reporting foreshadowed the eventual prosecution and conviction of Drexel and Milken. Unfortunately, no other case in recent financial history involved such extensive leaking from official sources. From early 1986 through 1989, leaks about Drexel from congressional staff, the SEC, and the U.S. Attorney’s office provided regular grist for the daily financial pages.

The lesson for regulators is that leaks can adversely influence policymaking and judicial outcomes. They create public perceptions that may be difficult to dispel or change. In the Drexel case, leaks by public officials created an environment that blunted the impact of public proceedings. Leaks also engendered in subtle ways public disrespect for the institutions those public officials represented and shortchanged the public they served.

Lessons for Corporations

The rise and fall of Drexel has important lessons for the American corporation and the capital markets. It would be unfair to deny Drexel’s contribution to the financing of mid-size entrepreneurial businesses. To its credit, Drexel saw the need for these companies to ac-

cess the public markets with non-investment-grade bonds. That the high-yield market has not only endured but grown since Drexel’s bankruptcy points up the importance of the firm’s contribution. It is unfortunate that Drexel did not concentrate its efforts on this market and look upon the emergence of competitors as favorable to the long-term viability of the market it had created. Instead, Milken embarked on a self-destructive path to exclude competitors and to engage in activities far afield from financing entrepreneurial businesses.

It is ironic that Drexel has been identified with takeovers and management buyouts when in fact the use of high-yield bonds for these purposes came some time after Milken had developed the high-yield market. What Milken did was to let less creditworthy, even marginal, entrepreneurs into the takeover and management buyout game through high-yield bond financing. Without access to the high-yield market through Milken, they would have remained on the sidelines.

Now that a few years have elapsed since the frenzied restructurings of the 80s, we can see that there may have been more important factors at work in fostering takeovers and management buyouts than high-yield bonds, overpaid investment bankers, or takeover entrepreneurs. Margaret Blair of Brookings has identified the difference between the high cost of capital in the 1980s and the low returns earned by many corporations as one of these factors. During the 1970s and early 1980s, many corporate managements failed to produce returns on existing assets commensurate with investors’ opportunity costs, and misallocated capital to acquisitions that failed to produce returns covering the cost of capital. Corporate restructurings aimed to increase cash returns for investors by reducing investment, lowering taxes, and cutting expenses.

Unfortunately, the use of takeovers and management buyouts to improve corporate performance was only partially successful. Many of these deals left restructured firms in weak condition leading to Chapter 11; others resulted in mediocre performance compared with expected returns. Drexel, particularly toward the end of the decade, acted as underwriter for more than its share of these deals. The “discipline of debt” could not work wonders on firms already in weak condition or burdened with new capital structures overleveraged in relation to cash flows.

The need to find ways to improve corporate performance remains. An overall assessment of the effectiveness of takeovers and buyouts in improving returns to investors may have to await more years of business experience. It is also much too early to assess the effectiveness of corporate governance changes as a way to improve performance. But whatever these final assessments may be, America cannot depend on one party—institutional investors, Wall Street, or the persona of man or firm—to accomplish that objective. What may be needed are changes in the way American institutions and corporations make their investment decisions. Drexel and Milken, in the sweep of financial history, will be seen as helping to point up that need. ■

Next Steps in Somalia

BY T E R R E N C E L Y O N S



The first phase of the international intervention in Somalia that began on December 9 is nearing a close. Recent clashes and violent demonstrations may delay the departure of the remaining U.S. forces deployed in Operation Restore Hope. The United States, however, remains committed to reducing its participation as soon as possible.

Now comes the hard part. From the beginning Washington has insisted that it would "hand off" control of the operation to the UN once U.S. forces had restored basic security. But the next phase of the intervention will be much more demanding than the initial pacification campaign, and it will require continued and concerted attention by Washington to succeed.

The UN's record in Somalia in 1991 and 1992, marked by a lack of vision and by bureaucratic disputes, raises serious doubts about its ability to manage the new responsibilities thrust upon it unless member states transform the organization. Even as it withdraws its troops, Washington should use its position as a world power to make sure that the UN operation has the military muscle, diplomatic prestige, and financial resources to act effectively. The Clinton administration seems prepared to commit several thousand U.S. troops to a UN operation that will be under the command of a Turkish general, an encouraging sign that Washington recognizes that new models of international cooperation are required.

The next stage in Somalia will require a more comprehensive political strategy than the initial, U.S.-led pacification campaign. In the short term, the UN will have to act as an interim authority responsible for such basic state functions as providing security and humanitarian relief.

At the same time, the UN must promote a process of political reconciliation among Somalis in order to create a new government. To succeed, the UN will have to bring new political leaders to the negotiating table and not limit participation to the warlords who stirred up the violence that necessitated the intervention in the first place.

Early U.S.-brokered agreements among warlords and the UN-sponsored January peace talks that were dominated by leaders of armed factions raised fears that the world community would be satisfied with a coalition of warlords as the next generation of Somali leaders. But bestowing recognition on political figures with dubious legitimacy in their own communities might impede long-term peace. Unless the transition process encourages new political leadership and institutions, the intervention will have failed to break the vicious cycle of violence in Somalia.

The pacification by U.S. forces already has eroded at least part of the power base of the warlords by reducing the effectiveness of military force as a political instrument and by denying them access to the looted food that financed their patronage networks. If factional leaders wish to shape Somalia's political future, they should have to demonstrate that they can represent real constituencies. Some may be able to make this transition and should be encouraged to do so; others will not and should be prevented from acting as spoilers.

The other side of the challenge is to encourage civil leaders to emerge and help build the new structures of authority. A broad array of potential leaders, including traditional elders, religious authorities, managers of

indigenous nongovernmental organizations, women, merchants, and intellectuals, has been forced into hiding (or exile) to survive the brutality of the past several years.

The warlords know that these leaders threaten their power and have intimidated or assassinated many. Given this very real threat, alternative leaders likely will remain in the shadows until they are convinced that the international community will not leave them to the mercy of the warlords again. Somalis will need time to find their collective voice and step forward to begin rebuilding local political structures.

International intervention has opened a window of opportunity for Somalis to determine their own fate. Severe budget constraints and the pressures of other obligations will tempt the world community to close that window quickly. But selecting legitimate spokespersons, forging and reforging alliances, and eventually creating new local and national institutions will take a long time, longer than Washington and the UN may yet realize.

Forcing too rapid a pace on the national reconciliation process will play into the hands of the warlords. A more deliberate pace, with patience on the part of foreigners when the inevitable setbacks occur, will permit authentic community leaders to emerge from Somali society—and in the process show how the international community may help rebuild societies that have collapsed. ■

Terrence Lyons is a senior research analyst in the Brookings Foreign Policy Studies program.

Turnout in the 1992 Election

BY RUY A. TEIXEIRA



Voter turnout rose smartly in the 1992 presidential election, from about 50 percent of the voting-age population in 1988 to about 55 percent. The increase was the first substantial one since 1960 (the only other increase since 1960 was a slight half percentage point in 1984). Turnout was also the best since 1972, when 55.2 percent of the electorate cast ballots.

That's the good news. The bad news is that 55 percent turnout is still quite anemic. It is 8 percentage points below that of the 1960 election, when a three-decade-long decline began. It is also about 25 percentage points below the average among other industrialized democracies. (But for Switzerland we would be in the cellar of the international rankings.) And finally, despite the big increase in 1992, turnout in the past three elections has averaged a little less than 53 percent. By way of comparison, the three elections of 1952, 1956, and 1960 averaged a little over 61 percent.

But if a 55 percent turnout in one election hardly solves America's low voter turnout problem, still the 5 percentage point increase is a change for the better and deserves an explanation. Why did more voters show up in 1992?

The most important explanation is that voter interest and involvement in the campaign increased sharply. Both polling data and the large audiences for the televised presidential debates confirm that. More voters "tuned in" to the campaign, and this involvement—despite the widespread low opinion of government and politicians (actually *more* negative than in 1988)—led to higher turnout.

But what caused the heightened interest? Several things. First, poor economic conditions provoked anxiety about the future. Voters were searching, almost against their better

judgment (given their cynicism about government), for political solutions to their problems. Second, the candidates themselves were unusually responsive to voters' interests and concerns. Bill Clinton ran as an "issues" candidate, with specific solutions to voters' problems. And Ross Perot put a number of issues on the table that might not otherwise have been there, as well as speaking to a vein of discontent about government that the other two candidates did not and could not fully engage.

In addition, the media were more helpful to voters in their campaign coverage than they were in 1988. Reporters were careful, if not paranoid, about being manipulated by negative campaigning and worked hard to avoid it. Campaign coverage, particularly in newspapers, but in television too, was oriented more toward issues. And there were simply *more* media outlets than before. Not everyone wants to read 10 campaign articles a day in the *Washington Post*. Some prefer "Larry King Live" or MTV for their political news. In 1992, voters had that choice.

Given that conditions for voter interest and involvement during 1992 were just about ideal, and that demographic changes (an older and more educated electorate) and liberalized registration (the increasing number of states with "motor voter" programs) also boosted turnout, an increase in turnout only to 55 percent is unimpressive. In fact, I would argue that 55 percent may be the upper bound of the possible under current political-institutional arrangements, since conditions for voter involvement are unlikely to be so compelling in every future election.

To avoid falling back to lower turnout levels and to stabilize turnout at a high

level—higher, one would hope, than 55 percent—we need to *institutionalize* the conditions that lead to high turnout. This means, for example, reforming the personal registration system to make voting easier. That reform alone could increase turnout as much as 8 percentage points.

We also need to institutionalize conditions that encourage voter interest and involvement. Here we must turn to political reform broadly defined. In terms of legislation we should consider regulating campaign advertising—at a minimum providing free television time to candidates to explain their position on the issues. The traditional objection that the public would not tune in to such unadorned issue presentation seems untenable in light of the 1992 campaign and Perot's "infomercials." We should also consider campaign finance reform, with a public financing component, to make campaigns less money-driven, more competitive, and more appealing to the public.

Reform should also be pursued from the bottom up, in terms of the institutions that connect citizens to politics—increasingly the media rather than political parties. Most important here is issues-based media coverage of campaigns. Experimental "user-friendly" issues coverage, especially by newspapers like the *Wichita Eagle* and the *Charlotte Observer*, but also by some television stations and networks, was very well received by voters.

Thus, while we should take heart from the 1992 election results—turnout can go up, not just down—much remains to be done. Absent a combination of substantial registration and political reforms, turnout is unlikely to rise much above its level in 1992 and may even fall again. ■

Ruy A. Teixeira is the author of *The Disappearing American Voter* (Brookings, 1992).

An End to the War on Waste

BY PAUL LIGHT



Paul Light is professor of public affairs at the Humphrey Institute, University of Minnesota, and a senior fellow of the Governance Institute. He is the author of Monitoring Government: Inspectors General and the Search for Accountability (Brookings/Governance Institute: 1993).

The Cold War was not the only war put behind us during the Bush years. So, too, apparently, was the war on waste. We haven't had a big procurement scandal for five years now, and Ronald Reagan's estimate of \$100 billion lost each year is long forgotten. In spite of occasional reports from the General Accounting Office showing that government is still losing billions to antiquated accounting systems, poorly managed contracts, and ill-conceived programs, the war on waste is off the front page.

The question is what to do with the troops who fought the war—the 12,000 or so auditors and investigators who work in more than 60 federal Offices of Inspector General (OIGs) created between 1978 and 1988. Launched by Congress in 1976 at the Department of Health, Education, and Welfare, and expanded across government in 13 different waves over the next decade, these offices remain nearly invisible to those of us outside government, only occasionally popping up in stories about scandals such as the one over President Clinton's passport. Yet the OIGs were among the few units in government that actually prospered during the 1980s. Their staffing went up almost a quarter; funding, even faster.

Theirs was a classic "body count" war, giving Ronald Reagan and his beleaguered Office of Management and Budget the only good statistics on a map of spreading red ink: over \$100 billion in OIG savings won through recoveries of missing funds, fines, and other improvements in how we spend federal dollars over the first 10 years. Their achievements did not go unnoticed in the White House. Even as most domestic agencies were being cut back, Reagan gave the OIGs new staff and resources. The more the OIGs could

show that the war was being won, the more they would get in next year's budget.

Meanwhile, other offices in government sacrificed for the war on waste—evaluation units, offices of budget and policy analysis, procurement and personnel shops all lost staff to the OIGs under Reagan. When agencies grew overall, the OIGs always grew faster; when agencies shrank, the OIGs always shrank more slowly.

Even though we seem to have stopped talking about waste, the OIGs continue to fight the good fight. Each year they set new records in savings and indictments. Each year they report growing statistical success against what seems to be an unyielding tide of inefficiency.

But the war they're fighting may not be winnable, at least not the way it's been fought. For all their efforts, the OIGs have mostly focused on a narrow war of attrition in which they mop up the fraud, waste, and abuse after it occurs. They patrol the territory, spot the incursion, audit and investigate with guns blazing, recover the money, indict the bad guys, then wait for the next attack. They did not do their jobs poorly, but may have been doing the wrong jobs.

What we now realize is that government cannot win a war on waste without attacking the enemy at the source. Fighting waste after it takes place is expensive, demoralizing, and, as the OIG yearly records suggest, never-ending. What we need to do is prevent the incursions in the first place, starting with a modern financial management system, and the computers to go with it. We must create the capacity within the government to recognize and prevent inefficiency in the design and implementation of new programs, and we must design

incentives for doing the right thing in the first place. We are now talking about reinventing government, not rooting out waste, about restructuring and flattening agencies, not busting fraud.

Can the OIGs play a role in this new management agenda? Two features of their operations suggest they can. First, the OIGs remain independent from the partisan pressures that often emerge on Capitol Hill and the White House. They are required to report to both Congress and the president and are "creatures" of neither, and they have enormous autonomy in how they staff and run their offices.

Second, several OIGs have already shown a willingness to engage in the kinds of program evaluation we need to design more "workable" programs in the first place. The Health and Human Services OIG, for example, has developed a strong evaluation capacity that provides quick-and-dirty studies of immediate value to the secretary. This blend of speed and independence can bring a fresh perspective to both ends of Pennsylvania Avenue about designing more effective programs.

Pledged to free government from second-guessing and endless internal regulation, President Clinton may have far less interest in being kept apprised of the latest OIG savings record and much more in how the OIGs can participate in a full-scale reinventing of government. Will he ask the OIGs to give up their body-count mindset? Trained and rewarded for one kind of war on waste, will the OIGs be able to adapt to the new president's new management order? If they cannot, they may go the way of the 16-inch-gun battleship, an instrument no longer needed in a vastly changed environment. ■

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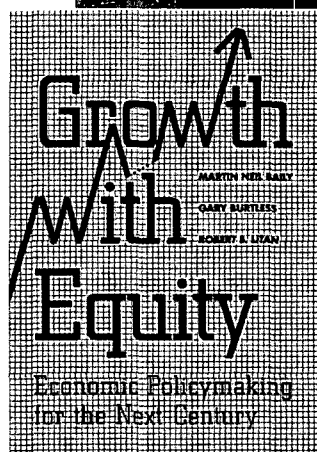
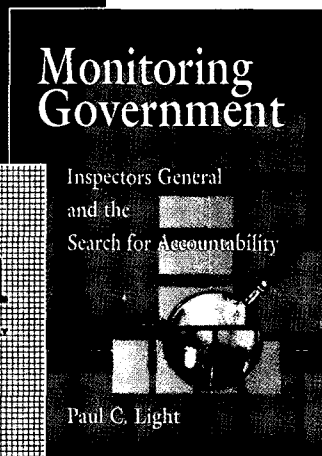
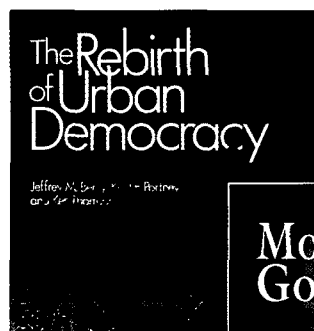
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